	2003 Legislative Proposals	
1	03-1	Child and Dependent Care Credit For Nonresidents And Part-Year Residents
2	03-2	Exemption/Golden State Scholarshare Trust Technical Clean-Up
3	03-3	Exempt Organizations/Bingo Gaming And Other Activities
4	03-6	Deemed Denials Clean-Up
5	03-9	Exclude LIFO Recapture Tax From Estimated Tax Underpayment For C Corporations Electing S Corporation Treatment
6	03-11	Definition Of “Taxable year” For Calendar Or Fiscal Years Beginning on Or After January 1, 2000
7	03-12	AB 1115 Clean-Up
8	03-14	Regulated Investment Companies Used To Avoid Tax
9	03-16	Erroneous Refund Interest Computation Simplification And Conformity
10	03-17	Exempt Organizations/Applications For Exemption Or Amending Articles Of Incorporation
11	03-22	Clarify Coordination Of U.S. Source Income & Subpart F Water’s Edge Partial Inclusion
12	03-23	Controlled Foreign Corporations In Water’s Edge Combined Report
13	03-24	Water’s-Edge Election Procedures
14	03-25	Clarify Whether IRC Sections 108 And 382 Are Applied On A Pre-Apportionment Or Post-Apportionment Basis
15	03-27	Prior Federal Elections And New California Taxpayers
16	03-28	Expanded Access To And Use Of “New Hire” Registry Information
17	03-29	Technical Changes
	2002 Taxpayer Bill of Rights Proposal	
18	02-2	Tax Treatment Of Dividends Paid By Regulated Investment Companies

LEGISLATIVE PROPOSAL 03-01
EXECUTIVE SUMMARY

- **Title:** Child and Dependent Care (CDC) Credit for Nonresidents and Part-Year Residents

- **Problem Statements:**
  1. California adjusted gross income (AGI) is used to determine the applicable percentage of federal CDC that may be claimed for the California CDC. This allows a nonresident and part-year resident with a low California AGI and a high federal AGI to claim the CDC where a resident with the same total income or federal AGI will not able to claim the CDC.
  2. The California CDC allows the credit for claimants who maintain a household in California. Consequently, claimants are able to include expenses incurred in other states in the calculation of their California CDC.

- **Proposed Solution:** Amend the Revenue & Taxation Code to:
  - Refer to an appropriate AGI definition (Problem No. 1),
  - Delete the requirement for the taxpayer to maintain a home in California (Problem No. 2), and
  - Clarify that employment-related child and dependent care expenses are required to have occurred within the state for purposes of the California CDC (Problem No. 2).

- **Major Concerns/Issues:** This proposal would correct a drafting error made when the California CDC was enacted in 2000 and correct a cross reference error created from a law change in 2002 so that the appropriate definition for AGI is used and the proper amount of credit for all residents, nonresidents, and part-year residents is allowed.

- **Revenue:** This proposal would result in annual revenue gains on the order of $450,000, beginning in 2003-04.

2003 Departmental Legislative Proposal
LP 03-01

Title

Child and Dependent Care Credit for Nonresidents and Part-Year Residents

Introduction

For purposes of the Child and Dependent Care Credit (California CDC) this proposal would:

- Delete the term “California adjusted gross income” (AGI), in favor of “federal AGI,” and
- Clarify the criteria for claiming the California CDC for nonresidents and part-year residents.

Current Federal Law

Existing federal law allows a non-refundable tax credit known as the federal Child and Dependent Care Credit (federal CDC). In order to take this credit, a taxpayer must have employment-related child and dependent care expenses for the care of a qualifying individual.

A qualifying individual for purposes of this credit is any dependent of the taxpayer who is under the age of 13 or a taxpayer’s dependent or spouse who is physically or mentally unable to care for him or herself. Employment-related child and dependent care expenses are generally defined as those expenses incurred to enable gainful employment, e.g., housekeeping, babysitting, and other household services.

Taxpayers must pay over half the cost of keeping up their primary home for the qualifying individuals. Costs include rent, mortgage interest, real estate taxes, utilities, home repairs, and food eaten at home.

Beginning in 2003, the maximum amount of eligible employment-related expenses will be $3,000 for one qualifying individual and $6,000 for two or more qualifying individuals. The maximum credit amount will be 35%. Thus, the maximum credit is $1,050 if there is one qualifying individual and $2,100 if there are two or more qualifying individuals.

Current State Law

Existing state law allows a credit similar to the federal CDC. California tax law conforms to federal tax law regarding the amount and types of expenses and qualifying individuals for purposes of claiming the California CDC. The amount of the California CDC is simply based on a percentage of the taxpayer’s federal CDC depending on the taxpayer’s CA AGI.

Unlike the federal CDC, the California CDC is refundable.

The credit is limited to those taxpayers who maintain a household within the state. However, the law does not specify that the care for the qualifying individual must be within the state.

Generally, credits allowed to nonresident and part-year resident taxpayers are prorated using the ratio of AGI from sources within California over AGI from all sources. A credit is allowed in its entirety if the credit is conditioned upon a transaction wholly occurring in this state.

Problems

1. California AGI is used to determine the applicable percentage of federal CDC that may be claimed for the California CDC. This allows a nonresident and part-year resident with a low California AGI and a high federal AGI to claim the CDC where a resident with the same total income or federal AGI will not be able to claim the CDC.

2. The California CDC allows the credit for claimants who maintain a household in California. Consequently, claimants are able to include expenses incurred in other states in the calculation of their California CDC.

Proposed Solutions

Amend Section 17052.6 of the R&TC to:

- Refer to the appropriate AGI definition (Problems No. 1),
- Delete the requirement for the taxpayer to maintain a home in California (Problem No. 2), and
- Clarify that employment-related child and dependent care expenses are required to have occurred within the state for purposes of the California CDC (Problem No. 2).

Effective/Operative Date of Solution

As a tax levy, this proposal would be effective when chaptered and operative for taxable years beginning on or after January 1, 2003.

Justification

This proposal would correct a drafting error made when the California CDC was enacted in 2000 and correct a cross reference error created from a law change in 2002. Specifically, it would provide the appropriate definition for AGI and would ensure the proper amount of credit for all residents, nonresidents, and part-year residents.

This proposal would also reduce the number of nonresident taxpayers who claim the credit because they maintain a vacation home in California or are in California for a transitory period of time but incur employment-related child and dependent care expenses for the qualifying individual outside of California.

Implementation

Implementing this proposal would require some changes to tax forms and instructions but this could be accomplished during the normal annual update of forms and procedures.

Fiscal Impact

Departmental Costs

No departmental costs are associated with this proposal.

Tax Revenue Estimate

This proposal would result in a projected total revenue gain on the order of $450,000 annually beginning in fiscal year 2003-4. The following is a breakdown of this total:

It is projected that using federal AGI instead of California AGI would result in a revenue gain on the order of $300,000. To determine the revenue gain, the total number of nonresident taxpayers claiming the California CDC based on California AGI was compared to the number of nonresident taxpayers who would claim the CDC based on their federal AGI. Of those two groups, only the taxpayers whose allowable credit percentage would change were counted for this estimate. For instance, those taxpayers who were claiming a 63% credit under California AGI when required to use the federal AGI would now claim the 53%, 42%, or zero credit. A ratio was calculated between the difference of California AGI and federal AGI percentages. This ratio was multiplied by the total number of nonresident CDC returns that was then multiplied by the average amount of credit claimed per nonresident CDC return. This results in a minor gain to state tax revenues because there would be fewer nonresident taxpayers who could claim the CDC.

It is projected that requiring employment-related child and dependent care expenses to be incurred within the state would result in an insignificant gain of less than $150,000 to California state tax revenues because only a small group of nonresident taxpayers would be affected by this change.

Other States

Massachusetts does not allow a credit but allows taxpayers a deduction that exceeds the federal limit on employment related expenses for dependent care services. Nonresidents and part-year residents must prorate this deduction based upon the amount of their Massachusetts-sourced income to total income.

Minnesota allows taxpayers a refundable credit similar to California's CDC. However, it is not a percentage of the federal CDC but instead is based on household income level. Nonresidents, part-year residents, and Native Americans must prorate the credit based on the amount of earned income taxable to Minnesota.

New York also allows taxpayers a refundable credit similar to California's CDC. It is based on a percentage of the federal CDC depending on the amount of the taxpayer's New York AGI. For nonresidents, the amount to be refunded is based on the New York income adjustments made to the federal AGI. For part-year residents, the amount to be refunded is based on the ratio of resident period income to the combined income from both the resident and nonresident periods.

Florida only has a corporation income tax therefore the CDC is not applicable. *Illinois* and *Michigan* do not offer a credit or a deduction to taxpayers for child and dependent care expenses.

LEGISLATIVE STAFF CONTACT

Darrine Distefano	Brian Putler
Franchise Tax Board	Franchise Tax Board
845-6458	845-6333

Darrine.Distefano@ftb.ca.gov Brian.Putler@ftb.ca.gov

Analyst Darrine Distefano
Telephone # 845-6458
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-01

AMENDMENT 1

SEC. Section 17052.6 of the Revenue & Taxation Code is amended to read:

17052.6. (a) For each taxable year beginning on or after January 1, 2000, there shall be allowed as a credit against the "net tax" (as defined in Section 17039) an amount determined in accordance with Section 21 of the Internal Revenue Code, except that the amount of the credit shall be a percentage, as provided in subdivision (b) of the allowable federal credit without taking into account whether there is a federal tax liability.

(b) For the purposes of subdivision (a), the percentage of the allowable federal credit shall be determined as follows:

(1) For taxable years beginning before January 1, 2003:

If the ~~California~~ adjusted gross income is:	The percentage of credit is:
$40,000 or less	63%
Over $40,000 but not over $70,000................	53%
Over $70,000 but not over $100,000...............	42%
Over $100,000	0%

(2) For taxable years beginning on or after January 1, 2003:

If the ~~California~~ adjusted gross income is:	The percentage of credit is:
$40,000 or less	50%
Over $40,000 but not over $70,000................	43%
Over $70,000 but not over $100,000...............	34%
Over $100,000	0%

(c) In the case of a taxpayer whose credits provided under this section exceed the taxpayer's tax liability computed under this part, the excess shall be credited against other amounts due, if any, from the taxpayer and the balance, if any, shall be paid from the Tax Relief and Refund Account and refunded to the taxpayer.

(d) For purposes of this section, ~~California~~ adjusted gross income means ~~California~~ federal adjusted gross income as computed for purposes of Section ~~17041~~ 17024.5(h)(2).

(e) The credit authorized by this section shall be limited to ~~those taxpayers who, during the taxable year, maintain a household,~~ employment-related expenses, within the meaning of Section 21~~(e)(1)~~ of the Internal Revenue Code, ~~that is located within this state~~ but only for child care services or care provided in this state and only to the extent of earned income (within the meaning of Section 21(d) of the Internal Revenue Code) from sources within this state.

(f) For purposes of this section, Section 21(b)(1) of the Internal Revenue Code, relating to a qualifying individual, is modified to additionally provide that a child (as defined in Section 151(c)(3) of the Internal Revenue Code) shall be treated, for purposes of Section 152 of the Internal Revenue Code (as applicable for purposes of this section), as receiving over one-half of his or her support during the calendar year from the parent having custody for a greater portion of the calendar year, that parent shall be treated as a "custodial parent" (within the meaning of Section 152(e) of the Internal Revenue Code, as applicable for purposes of this section), and the child shall be treated as a qualifying individual under Section 21(b)(1) of the Internal Revenue Code, as applicable for purposes of this section, if both of the following apply:

(1) The child receives over one-half of his or her support during the calendar year from his or her parents who never married each other and who live apart at all times during the last six months of the calendar year.

(2) The child is in the custody of one or both of his or her parents for more than one-half of the calendar year.

(g) The amendments to this section made by the act adding this subdivision shall apply only to taxable years beginning on or after January 1, 2002.

LEGISLATIVE PROPOSAL 03-02
EXECUTIVE SUMMARY

- **Title:** Exemption/Golden State Scholarshare Trust Technical Clean Up

- **Problem Statement:** The section of law providing for the exempt status of the Scholarshare Trust was inadvertently placed in the gross income chapter of the Corporations Tax Law (CTL) instead of the exempt corporations chapter of the CTL.

- **Proposed Solution:** Renumber the Scholarshare Trust Section to place it in the exempt corporations chapter (Chapter 4, Article 1 – exemptions from this part) of the CTL.

- **Major Concerns/Issues:** Implementing this proposal would not affect the department's programs and operations.

- **Revenue:** This proposal would not impact the state's income tax revenue or the Franchise Tax Board's administration of state income tax.

2003 Departmental Legislative Proposal
LP 03-02

Title

Exemption/Golden State Scholarshare Trust Technical Clean Up

Introduction

This proposal would renumber the section of law allowing the exempt status of the Golden State Scholarshare Trust (Scholarshare).

Program History/Background

The Scholarshare, administered by the Student Aid Commission, was established in California in 1998. Scholarshare is a tuition prepayment program that allows purchasers to pay in advance for educational costs of a designated beneficiary at a participating institution. The program collects all payments into one large fund and invests it with the goal of achieving a rate of return higher than the anticipated rate of tuition increases at participating colleges. When the beneficiary enrolls at a participating college, funds are withdrawn to pay tuition and fees and any other prepaid expenses, such as housing costs.

Current Federal Law

Under federal law, Internal Revenue Code Section 529 provides tax-exempt status to “qualified tuition programs.” No amount is included in the gross income of a contributor to, or a beneficiary of, a qualified state tuition program with respect to any distribution from, or earnings under, such program, except to the extent such distributions exceed qualified higher education expenses.

Current State Law

California law conforms to federal law as it relates to tax-exempt qualified tuition programs. Distributions, earnings, or contributions to or from the Scholarshare under the Revenue and Taxation Code (R&TC) are excluded from gross income during the taxable year.

Problem

The section of law providing for the exempt status of Scholarshare was placed in the gross income chapter of the Corporations Tax Law (CTL), instead of the exempt corporations chapter of the CTL.

Proposed Solution

Renumber the Scholarshare Trust Section to place it in the exempt corporations chapter (Chapter 4, Article 1 – exemptions from this part) of the CTL.

Effective/Operative Date of Solution

This proposal would be effective and operative beginning on or after January 1, 2004.

Justification

The R&TC is organized in a manner to align subject matter within specific divisions, chapters, and articles. Such organization eases locating specific information and interpreting the income tax laws. Renumbering the provision of law authorizing tax-exempt status for Scholarshare would conform the placement of that provision to the organizational structure of the R&TC.

Implementation

Implementing this proposal would not affect the department's programs and operations.

Fiscal Impact

Departmental Costs

No departmental costs are associated with this proposal.

Tax Revenue Estimate

This proposal would not impact the state's income tax revenue or the Franchise Tax Board's administration of state income tax.

Other States

This proposal relates to the organization of the California R&TC. Accordingly, a comparison to other states is not significant.

LEGISLATIVE STAFF CONTACT

Darrine Distefano
Franchise Tax Board
845-6458
Darrine.Distefano@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
Brian.Putler@ftb.ca.gov

Analyst Darrine Distefano
Telephone # 845-6458
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-02

AMENDMENT 1

SEC. Section 24328 of the Revenue & Taxation Code is renumbered to read:

~~24328~~ 23711.5 The Golden State Scholarshare Trust, established pursuant to Article 19 (commencing with Section 69980) of Chapter 2 of Part 42 of the Education Code, is an instrumentality of this state and the income of the Scholarshare trust shall be exempt from taxes imposed under this part. The Scholarshare trust is established and shall be maintained as a qualified state tuition program as defined in Section 529 of the Internal Revenue ~~Code, as added by Section 1806 of the Small Business Job Protection Act of 1996 (P.L. 103-188)~~ Code.

LEGISLATIVE PROPOSAL 03-03
EXECUTIVE SUMMARY

- **Title:** Exempt Organizations/Bingo Gaming

- **Problem Statement:** Current law is ambiguous with regard to Franchise Tax Board's (FTB) authority to revoke the tax-exempt status of an organization that violates the bingo gaming provisions under the Penal Code.

- **Proposed Solution:** Amend the Revenue & Taxation Code to clarify that violating the bingo gaming statute under the Penal Code is basis for revoking the tax-exempt status of an exempt organization.

- **Major Concerns/Issues:** Implementing this proposal would improve the department's ability to administer laws relating to exempt organizations and bingo activity.

- **Revenue:** This proposal would not impact the state's income tax revenue or FTB's administration of the state income tax.

2003 Departmental Legislative Proposal
LP 03-03

Title

Exempt Organizations/Bingo Gaming

Introduction

This proposal would clarify that when an organization violates the laws governing bingo gaming, its tax-exempt status may be revoked.

Program Background

An organization is required to apply to the Franchise Tax Board (FTB) to obtain tax-exempt status. The application must include a list of activities the organization will use to raise funds for charitable purposes. Over time, some exempt organizations have adopted bingo gaming as the primary activity. Once bingo becomes the primary activity and source of income, the organization's tax-exempt status becomes questionable. The applicable law is unclear whether these organizations should continue to benefit from tax-exempt status.

Current Federal Law

Federal law allows certain organizations, corporations, foundations, civic leagues, clubs, associations, and various other types of entities to be exempt from taxation. There are no federal provisions relating to exemptions for bingo. However, federal law does subject income of exempt organizations from certain types of bingo (e.g., pull-tabs) to a tax. This tax is known as the unrelated business income tax.

Current State Law

The Revenue & Taxation Code (R&TC) exempts certain nonprofit organizations from tax: qualified trusts, churches, service organizations, public charities, social clubs, and educational organizations. Although California adopts many federal definitions of qualifying organizations by incorporation with minor changes, it still maintains several separate definitions.

Under the R&TC, FTB is required to determine whether to grant an organization exemption from tax when the application and filing fee are submitted to the department.

Under state law, organizations may be exempt if they are organized and operated specifically for purposes as described in the R&TC, such as religious, charitable, scientific, or educational. Profits or earnings must not benefit any private shareholder or individual. An exempt organization that conduct bingo games will not be disqualified from exempt status if it conducts bingo games in accordance with provisions of the Penal Code. However, the proceeds from bingo games must be used exclusively for charitable purposes.

Under the California Penal Code, a city, county, or city and county may issue a license to conduct bingo games to an organization that is exempt under the R&TC. The proceeds from the bingo games must be used for charitable purposes. It is a misdemeanor punishable by a fine for exempt organizations to receive or pay a profit, wage, or salary from any bingo game. Proceeds received from bingo must be kept in a separate fund or account until used.

Problem

Current law is ambiguous with regard to FTB's authority to revoke the tax-exempt status of an organization that violates the bingo gaming provisions under the Penal Code.

Proposed Solution

Amend the R&TC to clarify that violating the bingo gaming statute under the Penal Code is basis for revoking the tax-exempt status of an exempt organization.

Effective/Operative Date of Solution

This proposal would be effective and operative beginning January 1, 2004.

Justification

This proposal would strengthen FTB's authority to enforce the laws governing the tax-exempt status of an exempt organization engaged in bingo gaming. As a result, exempt organizations would be inclined to ensure that their bingo gaming activities are in compliance with both the R&TC and the Penal Code.

Implementation

Implementing this proposal would improve the department's ability to administer laws relating to exempt organizations and bingo activity.

Fiscal Impact

Departmental Costs

No departmental costs are associated with this proposal.

Tax Revenue Estimate

This proposal would not impact the state's income tax revenue or FTB's administration of the state income tax.

Other States

Illinois and *Massachusetts* impose a tax for conducting bingo games. *Florida*, *Michigan,* and *Minnesota* do not impose a tax for bingo games. *New York* requires organizations to pay a percentage of its proceeds to the clerk of the municipality where the bingo game was held. To operate a bingo game in any of these states, the organization must be licensed by the state and operate without profit to its members. In *Illinois* and *Michigan*, the organization must be a licensed, bona fide religious, charitable, labor, fraternal, youth athletic, senior citizens', educational, or veterans' organization within the state. However in *Florida*, if the organization is not operated as a non-profit, religious, or charitable, the proceeds of the bingo game can be given in the form of prizes. In *Illinois, Massachusetts, Michigan*, and *Minnesota*, the proceeds of the game are to be devoted exclusively to the lawful purposes of the qualified organization. If any of these organizations violate the licensing requirements, the gaming license is revoked.

LEGISLATIVE STAFF CONTACT

Darrine Distefano	Brian Putler
Franchise Tax Board	Franchise Tax Board
845-6458	845-6333
Darrine.Distefano@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Darrine Distefano
Telephone # 845-6458
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S PROPOSED AMENDMENTS TO LP 03-03

AMENDMENT 1

SEC. Section 23710 of the Revenue & Taxation Code is amended to read:

23710. Any organization exempted from taxes imposed under this part pursuant to the provisions of this article shall not be disqualified for such exemption on the basis that it conducts bingo games pursuant to Section 326.5 of the Penal Code, provided that the profits or proceeds from those games are used in accordance with Section 326.5 of the Penal Code ~~exclusively for charitable purposes~~.

AMENDMENT 2

SEC. Section 23777 of the Revenue & Taxation Code is amended to read:

23777. The exemption granted to any organization under the provisions of Article 1 (commencing with Section 23701) of this chapter may be revoked by the Franchise Tax Board if the organization fails to--

(a) File any return required under this chapter or pay any amount due under this part or Part 10.2 (commencing with Section 18401) on or before the last day of the 12th month following the close of the taxable year;

(b) Comply with Section 19504 (relating to powers of the Franchise Tax Board to examine records and subpoena witnesses); or

(c) Confine its activities to those permitted by the section under which the exemption was granted.

(d) Comply with the requirements of Section 326.5 of the Penal Code, relating to bingo games for charity, with respect to the conduct of those games and the use of profits or proceeds from those games.

LEGISLATIVE PROPOSAL 03-06
EXECUTIVE SUMMARY

- **Title:** Claims For Refund/Deemed Disallowed Process

- **Problem Statement:** Taxpayer representatives have begun to use a new tactic to avoid participation in the administrative process for claims for refund. Through refusal to provide any information to FTB's requests for information needed to validate a claim for refund, the representative can deem the claim disallowed after six months, thereby allowing an immediate appeal to BOE. Such an appeal circumvents the statutorily required factual development of an audit and claim for refund by FTB.

- **Proposed Solution:** Amend the Revenue and Taxation Code to prohibit taxpayers or their representatives from deeming a claim for refund disallowed if the taxpayer has been requested to provide information in connection with an examination of the claim or the taxpayer has filed a claim during an audit.

- **Major Concerns/Issues:** This proposal would curtail a growing problem with the deemed disallowed process.

- **Revenue:** The revenue impact associated with this proposal is unknown. Based on current trends, any of the cases that would be impacted by this proposal could easily consist of claims amounting to millions of dollars.

2003 Departmental Legislative Proposal
LP 03-06

Title

Claims For Refund/Deemed Disallowed Process

Introduction

This proposal seeks to eliminate recently discovered abuse of the deemed disallowance process by limiting the circumstances under which a claim for refund can be deemed disallowed by a taxpayer.

Current Federal Law

Taxpayers are required to file a claim for refund or credit prior to filing a suit in federal court for the recovery of any tax that is alleged to be erroneously or illegally assessed or collected, any penalty claimed to be collected without authority, or any sum alleged to be excessive or wrongfully collected. Taxpayers are allowed to file a suit for refund in federal court if the Internal Revenue Service fails to take action on a claim for refund or credit within six months of the claim being filed by the taxpayer. Further, a taxpayer may not file a suit after two years have elapsed from the date of the mailing of the notice that disallowed the part of the claim in which the suit or proceeding relates.

Current State Law

Generally, a taxpayer may file a claim for refund within four years from the date the tax return was timely filed, four years from the due date of the tax return, or one year from the date of any overpayment. A taxpayer may file a claim for refund at any point during the above time frames, including during an ongoing FTB audit. A claim for refund must be submitted to FTB in writing and state the specific grounds for the refund request. If FTB disallows any claim for refund, the taxpayer must be notified and given an explanation for the disallowance. If FTB fails to mail a notice of action on any refund claim within six months after the taxpayer files the claim, the taxpayer may consider the claim disallowed and appeal to the Board of Equalization (BOE) or file a suit in court to recover the amount claimed as a refund.

There is no statutory provision preventing a taxpayer from deeming a claim for refund disallowed during an audit or protest.

Program History/Background

Claim For Refund

Upon receipt of a claim for refund, FTB may request more information from the taxpayer depending on the complexity of the case. Recently, taxpayer representatives have refused to provide FTB with reasonable information needed to substantiate the claim. As a result, FTB cannot fairly review the claim and issue a notice of action. These taxpayers simply wait the statutory six-month period to consider the claim disallowed and file an appeal with BOE.

In such a case, FTB can only argue that the taxpayer failed to meet the burden of proof required to show entitlement to the claim.

Audit

Generally, the department determines a taxpayer's correct tax administratively through means that include, but are not limited to, audits of returns and claims for refund. During an audit, the amount of communication between the department and the taxpayer and the amount of supporting documentation requested by the department will vary depending upon the type and complexity of the audit. At the conclusion, if the amount of tax reported on the taxpayer's tax return is less than the tax determined by FTB, the department issues a proposed assessment.

Problem

Taxpayer representatives have begun to use a new tactic to avoid participation in the administrative process for claims for refund. Through refusal to provide any information to FTB's requests for information that is needed to validate a claim for refund, the representative can deem the claim disallowed after six months, thereby allowing an immediate appeal to BOE. Such an appeal circumvents the statutorily required factual development of an audit and claim for refund by FTB.

Proposed Solution

Amend the Revenue and Taxation Code to prohibit taxpayers or their representatives from deeming a claim for refund disallowed if the taxpayer has been requested to provide information in connection with an examination of the claim or the taxpayer has filed a claim during an audit.

Effective/Operative Date of Solution

If enacted in the 2003 legislative session as an administrative measure, this proposal would be operative January 1, 2004, and would apply to claims for refund received after that date.

Justification

This proposal would curtail what appears to be abuse of the deemed disallowance process.

Implementation

Implementing this proposal would improve the department's ability to administer laws relating to claims for refund by ensuring that taxpayers comply with FTB's requests for information. Further, an audit or protest would be completed prior to processing the refund claim, which would ensure FTB has the information needed to accurately process the claim and make a proper determination.

Fiscal Impact

Departmental Costs

No departmental costs are associated with this proposal.

Tax Revenue Estimate

The revenue impact associated with this proposal is unknown. The revenue impact for this proposal would be determined by the dollar amount associated with claims that meet the deemed denial requirements and may also have a pending audit or protest before FTB for the same taxable year for which the claim was filed. Based on current trends, as discussed previously, any of the cases that would be impacted by this proposal could easily consist of claims amounting to millions of dollars.

Policy Considerations

The original intent of the deemed disallowance of a claim for refund was to ensure that taxpayers have a remedy in the event FTB were to misplace or fail to act on a claim for refund.

Other States

A review of the tax laws of *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York* found the following information related to processing claims for refund.

- *Florida* law does not specify a time frame for the processing of a claim for refund prior to its being deemed disallowed. Specifically, the law states that the Department of Revenue will examine claims for refund as soon as practicable.
- *Illinois* provides that the Department of Revenue will review claims for refund as soon as it is practicable. However, the claimant may file a written protest with the department if no action is taken in six months.
- *Minnesota* allows the taxpayer to take court action against the commissioner if no action has been taken in six months.
- *New York* allows a taxpayer to petition the tax commission if six months have expired since the claim was filed and no action has been taken.
- *Massachusetts* and *Michigan* have a claim for refund process, but the law was not specific to time frames for processing or taxpayer remedies if no action is taken on a claim.

None of the states tax laws were specific to the processing of claims for refund during an audit.

LEGISLATIVE STAFF CONTACT

LuAnna Hass	Brian Putler
Franchise Tax Board	Franchise Tax Board
845-7478	845-6333
LuAnna.Hass@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst LuAnna Hass
Telephone # 845-7478
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-06

AMENDMENT 1

@@@@ Section 19331 of the Revenue and Taxation Code is amended as follows:

19331. (a) If the Franchise Tax Board fails to mail notice of action on any refund claim within six months after the claim is filed, except as provided in subdivision (b), the taxpayer may prior to mailing of notice of action on the refund claim consider the claim disallowed and appeal to the board. For substitution of the 120-day period for the six-month period contained in this section in a Title 11 case, see Section 505(a)(2) of Title 11 of the United States Code.

(b)(1) If the Franchise Tax Board has contacted a taxpayer in writing requesting the taxpayer to furnish information with respect to a refund claim filed by the taxpayer, the taxpayer may not consider the claim disallowed under subdivision (a) until two years after the Franchise Tax Board first contacted the taxpayer in writing requesting information with respect to the claim.

(2) If the Franchise Tax Board has contacted a taxpayer in writing with respect to an examination of a return for a taxable year (other than a contact described in paragraph (1)), the taxpayer may not consider any claim for the same taxable year (irrespective of the date that claim is filed) disallowed under subdivision (a) until the latest of the following dates:

(A) If the Franchise Tax Board has mailed the taxpayer a notice of proposed deficiency assessment for the taxable year, either the date the Franchise Tax Board mails notice of action on the taxpayer's protest of the notice of proposed deficiency assessment for the taxable year (within the meaning of Section 19045), or the date the proposed deficiency assessment for the taxable year becomes final pursuant to Section 19042.

(B) If the Franchise Tax Board has not mailed the taxpayer a notice of proposed deficiency assessment for the taxable year, the date on which the period within which a notice of proposed deficiency assessment for the taxable year may be mailed to the taxpayer expires.

LEGISLATIVE PROPOSAL 03-09
EXECUTIVE SUMMARY

- **Title:** Exclude LIFO Recapture Tax from Estimated Tax Underpayment for C Corporations Electing S Corporation Treatment

- **Problem Statement:** There is a lack of coordination between LIFO (last-in, first-out) rules and estimated tax rules resulting in unnecessary confusion for corporate taxpayers that elect S corporation tax status.

- **Proposed Solution:** Amend R&TC Section 23802 to conform to IRS Rev. Proc. 94-61. Specifically, provide that the LIFO recapture tax is not included in the amount of estimated tax required to be paid for any taxable year when an installment of LIFO recapture tax is due.

- **Major Concerns/Issues:** None

- **Revenue:** Based on available data, the total LIFO recapture tax is not expected to exceed an average of $300,000 annually. This proposal provides for a postponement of tax due to the due date of the return rather than through quarterly estimate payments. The result is an insignificant initial cash flow loss (not exceeding $150,000) for fiscal year 2003-2004. Offsetting cash flow gains and losses will occur for future fiscal years.

2003 Departmental Legislative Proposal
LP 03-09

Title

Exclude LIFO Recapture Tax from Estimated Tax Underpayment for C Corporations Electing S Corporation Treatment

Introduction

This proposal would reconcile LIFO recapture provisions with estimated tax payment requirements.

Background

LIFO (last-in, first-out) is an inventory method of accounting for determining the value of opening and closing inventories where the most recently purchased or produced goods are deemed to be the first sold. Using LIFO in a period of rising prices results in a higher cost of goods sold and a lower taxable income than using other inventory valuation methods (e.g., FIFO (first-in, first-out) and cost-averaging methods).

Current Federal Law

Under existing federal law, and subject to certain restrictions, an eligible C corporation may elect to be taxed as a Subchapter S corporation. A C corporation is an ordinary corporation taxed under Subchapter C of the Internal Revenue Code (IRC) where it is recognized as a taxpaying entity. A corporation that makes the election to be subject to Subchapter S of the IRC is known as an S corporation. An S corporation passes items of income, loss, deductions, and credits through to the shareholders to be reflected on the individual shareholder's tax return.

If a C corporation uses the LIFO method of accounting for its inventory for the tax year before an S election becomes effective, it must add to income an amount called the LIFO recapture amount. The LIFO recapture amount is the difference between inventory valued using FIFO and LIFO. The additional tax due on this recaptured income is payable over four equal annual installments. The installments are due by the corporation's tax return due date (without extension) for the next four taxable years. For federal purposes, pursuant to IRS Revenue Procedure 94-61 as required by Internal Revenue Code Section 1363, the amount of tax imposed by reason of the LIFO recapture is not included in the amount of quarterly estimated tax payments a corporation is required to make for any of the taxable years for which a LIFO tax installment is due.

Current State Law

A C corporation with a valid federal S corporation election automatically becomes a California S corporation.

California law conforms to the federal LIFO recapture rules, including the benefit of allowing the tax to be paid in four equal annual installments due by the tax return due dates.

Technically, the LIFO recapture tax is a tax imposed by Part 11 of Division 2 of the Revenue and Taxation Code (R&TC), which current practice includes in the measure of estimated tax. This conflicts with the federal annual installment provisions to which California conforms.

Problem

There is a lack of coordination between LIFO rules and estimated tax rules resulting in unnecessary confusion for corporate taxpayers that elect S corporation tax status.

Proposed Solution

Amend R&TC Section 23802 to conform to IRS Rev. Proc. 94-61. Specifically, provide that the LIFO recapture tax is not included in the amount of estimated tax required to be paid for any taxable year when an installment of LIFO recapture tax is due.

Effective/Operative Date of Solution

If enacted in the 2003 legislative session as a tax levy, this proposal would be effective upon enactment and operative January 1, 2003.

Justification

California law conforms to federal law in requiring the recapture of LIFO benefits when a C corporation elects S corporation tax status and four annual payments of the resulting tax. The LIFO recapture tax is excluded from the determination of the amount of estimated tax a corporation is required to pay.

California law applicable to the interaction of the recapture of LIFO benefits and the requirement to pay estimated taxes is confusing because of conflicting provisions. Clarifying the conformity of California law to federal law in this instance provides certainty for corporate taxpayers.

Implementation

Implementing this bill would not significantly impact the department’s programs and operations.

Fiscal Impact

Departmental Costs

This bill would not significantly impact the department’s costs.

Tax Revenue Estimate

Based on available data, the total LIFO recapture tax is not expected to exceed an average of $300,000 annually. This proposal merely provides for a postponement of tax due to the due date of the returns rather than through quarterly estimate payments. The result is an insignificant initial cash flow loss (not exceeding $150,000) for fiscal year 2003-04. Offsetting cash flow gains and losses will occur for fiscal years 2004-05, 2005-06 and thereafter, however, the gain or loss is also expected to be insignificant.

Other States

Minnesota recognizes the federal relief provision and allows the resultant tax to be paid in four annual installments.

Florida, Illinois, Massachusetts, Michigan, and New York do not conform to the federal LIFO recapture relief provisions.

The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

LEGISLATIVE STAFF CONTACT

Norman Catelli	Brian Putler
Franchise Tax Board	Franchise Tax Board
845-5117	845-6333
Norm.Catelli@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Norman Catelli
Telephone # 845-5117
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-09

AMENDMENT 1

SEC. XX. Section 23802 of the Revenue and Taxation Code is amended to read:

23802. (a) Section 1363(a) of the Internal Revenue Code, relating to the taxability of an "S corporation," shall not be applicable.

(b) Corporations qualifying under this chapter shall continue to be subject to the taxes imposed under Chapter 2 (commencing with Section 23101) and Chapter 3 (commencing with Section 23501), except as follows:

(1) The tax imposed under Section 23151 or 23501 shall be imposed at a rate of 1 1/2 percent rather than the rate specified in those sections.

(2) In the case of an "S corporation" which is also a financial corporation, the rate of tax specified in paragraph (1) shall be increased by the excess of the rate imposed under Section 23183 over the rate imposed under Section 23151.

(c) An "S corporation" shall be subject to the minimum franchise tax imposed under Section 23153.

(d) (1) For purposes of subdivision (b), an "S corporation" shall be allowed a deduction under Section 24416 or 24416.1 (relating to net operating loss deductions), but only with respect to losses incurred during periods in which the corporation had in effect a valid election to be treated as an "S corporation" for purposes of this part.

(2) Section 1371(b) of the Internal Revenue Code, relating to denial of carryovers between "C years" and "S years," shall apply for purposes of the tax imposed under subdivision (b), except as provided in paragraph (1).

(3) The provisions of this subdivision shall not affect the amount of any item of income or loss computed in accordance with the provisions of Section 1366 of the Internal Revenue Code, relating to passthrough items to shareholders.

(4) For purposes of subdivision (b) of Section 17276, relating to limitations on loss carryovers, losses passed through to shareholders of an "S corporation," to the extent otherwise allowable without application of that subdivision, shall be fully included in the net operating loss of that shareholder and then that subdivision shall be applied to the entire net operating loss.

(e) For purposes of computing the taxes specified in subdivision (b), an "S corporation" shall be allowed a deduction from income for built-in gains and passive investment income for which a tax has been imposed under this part in accordance with the provisions of Section 1374 of the Internal Revenue Code, relating to tax imposed on certain built-in gains, or Section 1375 of the Internal Revenue Code, relating to tax imposed on passive investment income.

(f) For purposes of computing taxes imposed under this part, as provided in subdivision (b):

(1) An "S corporation" shall compute its deductions for amortization and depreciation in accordance with the provisions of Part 10 (commencing with Section 17001) of Division 2.

(2) The provisions of Section 465 of the Internal Revenue Code, relating to limitation of deductions to the amount at risk, shall be applied in the same manner as in the case of an individual.

(3) (A) The provisions of Section 469 of the Internal Revenue Code, relating to limitations on passive activity losses and credits, shall be applied in the same manner as in the case of an individual. For purposes of the tax imposed under Section 23151 or 23501, as modified by this section, material participation shall be determined in accordance with Section 469(h) of the Internal Revenue Code, relating to certain closely held "C corporations" and personal service corporations.

(B) For purposes of this paragraph, the "adjusted gross income" of the "S corporation" shall be equal to its "net income," as determined under Section 24341 with the modifications required by this subdivision, except that no deduction shall be allowed for contributions allowed by Section 24357.

(4) The exclusion provided under Section 18152.5 shall not be allowed to an "S corporation."

(g) The provisions of Section 1363(d) of the Internal Revenue Code, relating to recapture of LIFO benefits, shall be modified for purposes of this part to refer to Section 19101 in lieu of Section 6601 of the Internal Revenue Code. For purposes of Section 19023, relating the definition of “estimated tax,” and Section 19142, relating to an addition to tax for underpayment of estimated tax, the tax imposed pursuant to this subdivision shall not be considered a tax imposed by this part.

LEGISLATIVE PROPOSAL 03-11
EXECUTIVE SUMMARY

- **Title:** Definition of “Taxable Year” for Calendar or Fiscal Years Beginning On or After January 1, 2000

- **Problem Statement:** When the Revenue and Taxation Code (R&TC) definition of “taxable year” was changed in 2000, the explicit definition that “taxable year” means the year for which the tax is payable was repealed. However, an explicit definition of “taxable year,” which is also called the “privilege year,” is significant to the theory of a franchise tax and should be included in the R&TC.

- **Proposed Solution:** Amend the R&TC to explicitly define “taxable year” as the privilege year for which the franchise tax is payable.

- **Major Concerns/Issues:** None

- **Revenue:** This proposal has no identifiable state revenue impact.

2003 Departmental Legislative Proposal
LP 03-11

Title

Definition of "Taxable Year" for Calendar or Fiscal Years Beginning On Or After January 1, 2000

Introduction

This proposal would add a definition of the term "taxable year" for California franchise tax purposes that was inadvertently repealed for taxable years beginning on or after January 1, 2000.

Background

California tax law imposes a franchise tax for the privilege of doing business in California. For taxable years beginning prior to January 1, 2000, this tax was a "prepaid" tax, meaning the tax for the privilege of doing business in the current year (the *taxable* year) was measured by the amount of income earned during the prior year (*income* year). Thus, the "taxable year" was defined in Revenue and Taxation Code (R&TC) Section 23041 as the calendar year or fiscal year for which the tax is payable.

This "prepayment concept" was confusing and out of step with the manner other states imposed a franchise tax. As a result, in 2000, legislation was introduced that ended the "prepayment" concept making the current year, i.e., the "taxable year," the relevant concept for determining the period for which the franchise tax is due.

Current Federal Law

Federal law generally defines the term "taxable year" as:

1) The taxpayer's annual accounting period, if it is a calendar year or a fiscal year,
2) The calendar year, if the taxpayer has not been keeping books and records, or,
3) The period for which the return is made, if a return is made for a period of less than 12 months.

Current State Law

Current R&TC Section 24631 defines "taxable year" the same as federal law. R&TC Section 23041 also contains a definition of "taxable year" (for years beginning before January 1, 2000) that states that "taxable year" means the year for which the tax is payable. In addition, taxpayers are required to have the same taxable year for state purposes as for federal purposes, unless they have received permission from FTB to have a different taxable year.

Problem

When the R&TC definition of "taxable year" was changed in 2000, the explicit definition that "taxable year" means the year for which the tax is payable was repealed. However, an explicit definition of "taxable year," which is also called the "privilege year," is significant to the theory of a franchise tax and should be included in the R&TC.

Proposed Solution

Amend R&TC Sections 23041 to explicitly define “taxable year” as the privilege year for which the franchise tax is payable.

Effective/Operative Date of Solution

If enacted in the 2003 legislative session, this proposal would be effective on January 1, 2004.

Justification

Providing a definition of “taxable year” creates consistency within the R&TC provisions relating to the franchise tax. Clear definitions and internal consistency reduces the possibility of confusion and reduces complexity of the tax laws.

Implementation

Implementing this proposal would not impact the department’s programs and operations.

Fiscal Impact

Departmental Costs

This bill would not impact the department’s costs.

Tax Revenue Estimate

This proposal has no identifiable state revenue impact.

Other States

Florida, Illinois, Massachusetts, Michigan, Minnesota, **and** ***New York*** **define “taxable year” by** reference to the Internal Revenue Code.

The laws of these states were reviewed because their tax laws are similar to California’s income tax laws.

LEGISLATIVE STAFF CONTACT

Norman Catelli	Brian Putler
Franchise Tax Board	Franchise Tax Board
845-5117	845-6333
Norm.Catelli@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Norman Catelli
Telephone # 845-5117
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-11

AMENDMENT 1

SEC. XX. Section 23041 of the Revenue and Taxation Code is amended to read:

23041. "Taxable year" means:

(a) For ~~calendar or fiscal years beginning before January 1, 2000,~~ the purposes of the tax imposed under Chapter 2 (commencing with Section 23101), the calendar year, or the fiscal year for which the tax is payable.

(b) For the purposes of the tax imposed under Chapter 1.5 (commencing with Section 23081), Chapter 3 (commencing with Section 23501), or Chapter 4 (commencing with Section 23701), the calendar year or the fiscal year upon the basis of which the net income is computed.

(c) For purposes of the tax imposed under Chapter 2.5 (commencing with Section 23400), (1) in the case of a taxpayer subject to the tax imposed under Chapter 2 (commencing with Section 23101), the calendar year or the fiscal year for which the tax is payable and (2) in the case of a taxpayer subject to the tax imposed under Chapter 3 (commencing with Section 23501) or Chapter 4 (commencing with Section 23701), the calendar or fiscal year upon the basis of which the net income is computed.

(d) For the purpose of the taxes imposed under this part, a period of 12 months or less.

(e) When referring to a calendar or fiscal year beginning before January 1, 2000, upon the basis of which the net income is computed, the term "taxable year" shall mean "income year," as defined in subdivision (a) of Section 23042.

LEGISLATIVE PROPOSAL 03-12
EXECUTIVE SUMMARY

- **Title:** AB 1115 Clean-up—Clarification of Nonresident/Part-Year Resident Taxation

- **Problem Statement:** During the implementation of AB 1115 (Stats. 2001, Ch. 920), certain issues were identified that may be subject to more than one interpretation and, thus, need to be clarified. (1) The new "California adjusted gross income" definition does not explicitly reflect the repeal of former Section 17303 that provided a rule for the sourcing of income of part-year residents during the period of residency. (2) Section 17041 contains an incorrect cross-reference. (3) Section 17041 provides that when calculating the "taxable income of a nonresident or part-year resident," the amount of carryover items, deferred income, suspended losses, or suspended deductions shall only be includible or allowable to the extent that these items were derived from sources within this state. In other words, this paragraph, by implication, provides that the amount is to be calculated on a source basis for the current year and all prior years. However, this paragraph does not explicitly state the calculation is to be made as if the nonresident or part-year resident (for the period of nonresidency) was a nonresident for all prior years. (4) AB 1115 did not contain relief from estimated tax penalties for taxpayers being required to report more income under AB 1115 than under prior law.

- **Proposed Solution:** Amend Section 17301.3 to explicitly reflect the repeal of former Section 17303, amend Section 17041 to correct a cross-reference and explicitly provide that in calculating the "taxable income of a nonresident or part-year resident," the calculation of prior year items is to be made as if the nonresident or part-year resident (for the period of nonresidency) was a nonresident for all prior years. In addition, add Section 19136.11 to waive estimated tax penalties for the 2002 taxable year.

- **Major Concerns/Issues:** California law should contain clear guidelines with respect to the tax treatment of the income and deductions of nonresidents and part-year residents. This proposal would establish explicit rules that would be applied consistently to all taxpayers. It would ease the administration of California's laws and improve compliance by California taxpayers.

- **Revenue:** This proposal would not impact the State's revenue.

2003 Departmental Legislative Proposal
LP 03-12

Title

AB 1115 Clean-up—Clarification of Nonresident/Part-Year Resident Taxation

Introduction

This proposal would make changes to clarify the method of calculating the taxable income of nonresidents and part-year residents to eliminate concerns that were identified during the implementation of AB 1115 (Ch. 920, Stats. 2001).

Background

States are allowed to tax residents of that state on income earned by that resident, regardless of source. However, it is a fundamental federal Constitutional principle that nonresidents of a state are subject to tax by that state only upon their income from sources within that state. Thus, California lacks jurisdiction to tax nonresidents on income from sources outside this state.

AB 1115 (Stats. 2001, Ch. 920) made major changes to the manner that nonresidents and part-year residents compute their tax for taxable years beginning on or after January 1, 2002, to ensure that California does not tax nonresidents and part-year residents (for the period of nonresidency) on income from sources outside this state.

Current State Law

For taxable years beginning on or after January 1, 2002, a nonresident first determines the "average tax rate" that would apply to a resident having the same amount of total taxable income (TI) for the year. The second step is to then multiply that person's California source TI by the "average tax rate" determined in step one. The mathematical formula is:

$$\frac{\text{Tax on Total TI}}{\text{Total TI}} \times \text{California Source TI} = \text{Tax}$$

This formula clearly provides that the "average tax rate" is applied only to TI having a California source and is, therefore, consistent with the federal Constitutional principle that California lacks jurisdiction to tax nonresidents on income from sources outside this state.

In order to determine the "average tax rate" that would apply to a resident having the same amount of total TI for the year, current law provides that "taxable income of a nonresident or part-year resident" is to be determined on the entire TI of the nonresident or part-year resident as if the nonresident or part-year resident were a resident of this state for the taxable year, and as if the nonresident or part-year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions.

Current law also provides that when calculating the "taxable income of a nonresident or part-year resident," the amount of carryover items, deferred income, suspended losses, or suspended deductions shall only be includible or allowable to the extent that these items were derived from sources within this state. Thus, in order to determine the amount of California source TI that will be taxed at the "average tax rate," the amount of income and deductions must be recalculated on a source basis.

Problem

During the implementation of AB 1115 (Stats. 2001, Ch. 920), certain issues were identified that may be subject to more than one interpretation and, thus, need to be clarified.

1. AB 1115 added a definition of "California adjusted gross income" in Section 17301.3 to reflect the definition of that term that was contained in Section 17041, prior to its amendment by AB 1115. However, the new definition explicitly provides how a California nonresident is to determine their income from sources within this state but does not explicitly reflect the repeal of former Section 17303 that provided a rule for the sourcing of income of part-year residents during the period of residency.

2. Section 17041(i)(1)(B) contains an incorrect cross-reference.

3. Concerns have been raised regarding the sufficiency of the language contained in Section 17041(i)(3) with respect to the calculation of the amount (on a source basis) to be included in the "taxable income of a nonresident or part-year resident" of carryover items, deferred income, suspended losses, and suspended deductions by a nonresident or part-year resident (for the period of nonresidency).

   A. An analysis of Sections 17041(c)(2) and 17041(d)(2) shows that when a nonresident or part-year resident calculates his or her "average tax rate," they do so in the same manner as a California resident, that is, as if the nonresident or part-year resident were a resident of this state for the taxable year and as if the nonresident or part-year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions.

   B. Section 17041(i)(3) provides that when calculating the "taxable income of a nonresident or part-year resident," the amount of carryover items, deferred income, suspended losses, or suspended deductions shall only be includible or allowable to the extent that these items were derived from sources within this state. In other words, this paragraph, by implication, provides that the amount is to be calculated on a source basis for the current year and all prior years. However, this paragraph does not explicitly state the calculation is to be made as if the nonresident or part-year resident (for the period of nonresidency) was a nonresident for all prior years.

AB 1115 did not contain relief from estimated tax penalties for taxpayers being required to report more income under AB 1115 than under prior law.

Proposed Solution

1. Amend Section 17301.3 to explicitly reflect the repeal of former Section 17303 and the change made to Section 17041 with respect to part-year residents.

2. Amend Section 17041(i)(1)(B) to change the reference from “Section 17031” to “Section 17301” to correct the cross-reference to the beginning section of Article 9 of Chapter 3.

3. Amend Section 17041(i)(3) to explicitly provide that in calculating the “taxable income of a nonresident or part-year resident,” the calculation of prior year items is to be made as if the nonresident or part-year resident (for the period of nonresidency) was a nonresident for all prior years.

4. Add Section 19136.11 to waive estimated tax penalties for the 2002 taxable year.

Effective/Operative Date of Solution

This proposal, if enacted during 2003 as a tax levy, would be operative for taxable years beginning on or after January 1, 2003.

Justification

By providing detailed rules in the statute that specify how the computations for these complex calculations are to be made, this proposal would enable taxpayers and tax professionals to understand the law and thus result in improved compliance.

Implementation

This proposal would improve the department’s administration of state tax law by eliminating an area of ambiguity. Some tax forms and instructions would require change, but this could be accomplished during the normal annual update of forms and procedures.

Fiscal Impact

Departmental Costs

This proposal may result in minor but indeterminable departmental savings.

Tax Revenue Estimate

This proposal would not impact the State’s revenue.

Tax Revenue Discussion

This proposal is clean-up to AB 1115, providing clarification on the calculation of prior year items of a nonresident (carryover items, deferred income, etc.) to prevent future controversies.

Policy Considerations

California law should contain clear guidelines with respect to the tax treatment of the income and deductions of nonresidents and part-year residents. This proposal would establish explicit rules that would be applied consistently to all taxpayers. It would ease the administration of California's laws and improve compliance by California taxpayers.

Arguments Pro

Some taxpayers and their representatives will support these changes since they eliminate ambiguity in the law and will reduce the number of audits, protests, and appeals.

Also, this proposal is consistent with the fundamental federal Constitutional principal that nonresidents of a state are subject to tax by that state only upon their income from sources within that state.

Arguments Con

It may be argued by some that California nonresidents should not be allowed to deduct a carryover loss on their California nonresident return, if that loss was incurred prior to becoming a California nonresident and that loss was offset against income that was not from California sources while the person was a California resident. Such an argument, however, ignores the repeal of the "accrual" concept by AB 1115. Before 2002, California law provided that, in certain cases, the taxability of transactions occurring prior to a change in residency were to be determined on the last day before the change in residency. Starting in 2002, this "accrual" no longer exists and instead the California taxability of an item revolves solely around whether or not the item has a California source.

Other States

Florida has no comparable method of taxation of nonresidents of that state since it has no personal income tax.

Illinois allocates and apportions the income of nonresident individuals to determine the amount of income that is sourced to and, thus, is taxable by that state. Income of a part-year resident is sourced to Illinois for the part of the year that the individual was a resident, and apportioned inside and outside of the state for the part of the year the individual was a nonresident.

Under *Massachusetts* law, a nonresident is taxed only on income from sources within that state. Nonresidents are entitled to deductions only to the extent they relate to or are allowable against the income subject to tax in Massachusetts. The corporate rules for apportionment of income are used to determine the amount sourced and, thus, taxable where the nonresident has income from sources both inside and outside of the state. If the individual changes from resident to nonresident, or vice versa, during the year, the taxpayer is required to file two returns (i.e. a resident return for the portion of the year during which the taxpayer was a resident and a nonresident return for the other portion of the year).

Michigan provides that the TI of a nonresident is allocated to the state to the extent it is attributable to personal services rendered in Michigan or that is derived from business activities carried on in the state. Allocation and apportionment rules are provided for items such as business income, rents and royalties, gains and losses, interest and dividends, and income from patents and copyrights.

New York taxes nonresidents and part-year residents on TI derived from sources within the state. The New York source income of a nonresident is the amount of federal AGI derived from or connected with New York sources, including allowing a nonresident a deduction for alimony paid using the same ratio that their business income is apportioned to New York. The source income of a part-year resident is the sum of the federal AGI for the period of residence plus the New York source income for the period of nonresidence and certain special accruals.

Those states were examined due to similarities to California of those states' population and business activity.

LEGISLATIVE STAFF CONTACT

John Pavalasky
Franchise Tax Board
845-4335
John.Pavalasky@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
Brian.Putler@ftb.ca.gov

Analyst John Pavalasky
Telephone # 845-4335
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-12

AMENDMENT 1

SEC. . Section 17301.3 of the Revenue and Taxation Code is amended to read:

17301.3. For purposes of this part, in the case of a nonresident or part-year resident, the term "California adjusted gross income" ~~means~~ includes each of the following:

(A) For any part of the taxable year during which the taxpayer was a resident of this state (as defined by Section 17014), all items of adjusted gross income, regardless of source.

(B) For any part of the taxable year during which the taxpayer was not a resident of this state, adjusted gross income ~~for the entire year~~ derived from sources within this state, determined in accordance with Article 9 of Chapter 3 (commencing with Section 17301) and Chapter 11 (commencing with Section 17951) ~~and this article~~.

SEC. . Section 17041 of the Revenue and Taxation Code is amended to read:

17041. (a) There shall be imposed for each taxable year upon the entire taxable income of every resident of this state who is not a part-year resident, except the head of a household as defined in Section 17042, taxes in the following amounts and at the following rates upon the amount of taxable income computed for the taxable year as if the resident were a resident of this state for the entire taxable year and for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions:

If the taxable income is:	The tax is:
Not over $3,650....................	1% of the taxable income
Over $3,650 but not over $8,650......................	$36.50 plus 2% of the excess over $3,650
Over $8,650 but not over $13,650.....................	$136.50 plus 4% of the excess over $8,650
Over $13,650 but not over $18,950.....................	$336.50 plus 6% of the excess over $13,650
Over $18,950 but not over $23,950.....................	$654.50 plus 8% of the excess over $18,950
Over $23,950......................	$1,054.50 plus 9.3% of the excess over $23,950

(b) (1) There shall be imposed for each taxable year upon the taxable income of every nonresident or part-year resident, except the head of a household as defined in Section 17042, a tax as calculated in paragraph (2).

(2) The tax imposed under paragraph (1) shall be calculated by multiplying the "taxable income of a nonresident or part-year resident," as defined in subdivision (i), by a rate (expressed as a percentage) equal to the tax computed under subdivision (a) on the entire taxable income of the nonresident or part-year resident as if the nonresident or part-year resident were a resident of this state for the taxable year and as if the nonresident or part-year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions, divided by the amount of that income.

(c) There shall be imposed for each taxable year upon the entire taxable income of every resident of this state who is not a part-year resident for that taxable year, when the resident is the head of a household, as defined in Section 17042, taxes in the following amounts and at the following rates upon the amount of taxable income computed for the taxable year as if the resident were a resident of the state for the entire taxable year and for all prior taxable years for carryover items, deferred income, suspended losses, or suspended deductions:

If the taxable income is:	The tax is:
Not over $7,300.....................	1% of the taxable income
Over $7,300 but not over $17,300.......................	$73 plus 2% of the excess over $7,300
Over $17,300 but not over $22,300.......................	$273 plus 4% of the excess over $17,300
Over $22,300 but not over $27,600.......................	$473 plus 6% of the excess over $22,300
Over $27,600 but not over $32,600.......................	$791 plus 8% of the excess over $27,600
Over $32,600.........................	$1,191 plus 9.3% of the excess over $32,600

(d) (1) There shall be imposed for each taxable year upon the taxable income of every nonresident or part-year resident when the nonresident or part-year resident is the head of a household, as defined in Section 17042, a tax as calculated in paragraph (2).

(2) The tax imposed under paragraph (1) shall be calculated by multiplying the "taxable income of a nonresident or part-year resident," as defined in subdivision (i), by a rate (expressed as a percentage) equal to the tax computed under subdivision (a) on the entire taxable income of the nonresident or part-year resident as if the nonresident or part-year resident were a resident of this state for the taxable year and as if the nonresident or part-year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended

deductions, divided by the amount of that income.

(e) There shall be imposed for each taxable year upon the taxable income of every estate, trust, or common trust fund taxes equal to the amount computed under subdivision (a) for an individual having the same amount of taxable income.

(f) The tax imposed by this part is not a surtax.

(g) (1) Section 1 (g) of the Internal Revenue Code, relating to certain unearned income of minor children taxed as if the parent's income, shall apply, except as otherwise provided.

(2) Section 1(g)(7)(B)(ii)(II) of the Internal Revenue Code, relating to income included on parent's return, is modified, for purposes of this part, by substituting "1 percent" for "15 percent."

(h) For each taxable year beginning on or after January 1, 1988, the Franchise Tax Board shall recompute the income tax brackets prescribed in subdivisions (a) and (c). That computation shall be made as follows:

(1) The California Department of Industrial Relations shall transmit annually to the Franchise Tax Board the percentage change in the California Consumer Price Index for all items from June of the prior calendar year to June of the current calendar year, no later than August 1 of the current calendar year.

(2) The Franchise Tax Board shall do both of the following:

(A) Compute an inflation adjustment factor by adding 100 percent to the percentage change figure that is furnished pursuant to paragraph (1) and dividing the result by 100.

(B) Multiply the preceding taxable year income tax brackets by the inflation adjustment factor determined in subparagraph (A) and round off the resulting products to the nearest one dollar ($1).

(i) (1) For purposes of this part, the term "taxable income of a nonresident or part-year resident" includes each of the following:

(A) For any part of the taxable year during which the taxpayer was a resident of this state (as defined by Section 17014), all items of gross income and all deductions, regardless of source.

(B) For any part of the taxable year during which the taxpayer was not a resident of this state, gross income and deductions derived from sources within this state, determined in accordance with Article 9 of Chapter 3 (commencing with Section ~~17031~~ 17301 and Chapter 11 (commencing with Section 17951).

(2) For purposes of computing "taxable income of a nonresident or part-year resident" under paragraph (1), the amount of any net operating loss sustained in any taxable year during any part of which the taxpayer was not a resident of this state shall be limited to the sum of the following:

(A) The amount of the loss attributable to the part of the taxable year in which the taxpayer was a resident.

(B) The amount of the loss which, during the part of the taxable year the taxpayer is not a resident, is attributable to California source income and deductions allowable in arriving at taxable income of a nonresident or part-year resident.

(3) For purposes of computing "taxable income of a nonresident or part-year resident" under paragraph (1), any carryover items, deferred income, suspended losses, or suspended deductions

shall only be includible or allowable to the extent that the carryover item, deferred income, suspended loss, or suspended deduction was derived from sources within this state calculated as if the nonresident or part-year resident for the portion of the year he or she was a nonresident had been a nonresident for all prior years.

SEC. . Section 19136.11 is added to the Revenue and Taxation Code to read:

19136.11. (a) No addition to tax shall be made under Section 19136 for any period before April 15, 2003, with respect to any underpayment of an installment for the 2002 taxable year, to the extent that the underpayment was created or increased by any provision of Chapter 920 of the Statutes of 2001.

(b) The Franchise Tax Board shall implement this section in a reasonable manner.

LEGISLATIVE PROPOSAL 03-14
EXECUTIVE SUMMARY

- **Title:** Regulated Investment Companies (RIC) Used to Avoid Tax

- **Problem Statement:** Some banks are taking the position that the interest income on their loan portfolio disappears from the California tax base when they utilize a RIC structure. Based upon this structure, the bank takes the position that:
  - the RIC subsidiary has no net income that would be subject to California tax because the dividends paid by the RIC are tax deductible; and
  - dividends received by the bank from the RIC subsidiary are eliminated under R&TC Section 25106 as a dividend paid to a parent corporation that is unitary with its subsidiary.

- **Proposed Solution:** Amend the RIC rules to explicitly provide that dividends paid by a RIC to California corporate shareholders may not obtain the benefit of the exclusion from income under R&TC Section 25106 except for dividends received by the RIC from corporations that are unitary. Include "no inference" language so there will be no negative impact on current audits involving this issue.

- **Major Concerns/Issues:** The Securities and Exchange Commission (SEC) has indicated that it is considering withdrawing the registration of certain RICs. Revocation of registration would be for public policy purposes because the banks are transferring traditional banking activities to these RICs, and what they are doing apparently violates the intent of the 1940 Investment Company Act. In addition there is a question as to whether there is a valid transfer to the RIC as the bank is keeping the transfer “transparent” to its customers and retaining all control over the loan portfolios. This proposal would prevent the banks from treating the distributions from RICs as dividends for taxable years beginning on or after January 1, 2003, while legislative intent language would allow the taxpayers previously taking this deduction to litigate the department’s denial of this deduction for taxable years beginning before January 1, 2003.

- **Revenue:** For taxpayers identified as using the RIC structure, the tax effects of deducting dividend income twice totals approximately $42.7 million for the 2000 taxable year. Absent this legislative fix, departmental staff believes use of the RIC structure to avoid tax will increase profusely. That is $45 million for 2003-04 fiscal year growing to $65 million by the 2005-06 fiscal year.

2003 Departmental Legislative Proposal
LP 03-14

Title

Regulated Investment Companies (RIC) Used to Avoid Tax

Introduction

This proposal would clarify existing law by specifying that a distribution received from a RIC by a corporation is taxable to the corporation.

Current Federal Law

A RIC (commonly called a mutual fund) is a domestic corporation that at all times during the tax year is registered with the Securities Exchange Commission (SEC) under the 1940 Investment Company Act; meets gross income, diversification and earnings and profits (E&P) tests; makes certain distributions; and elects on its tax return to be taxed as a RIC.

A REIT is designed to do for real estate investors generally what a RIC does for investors in securities (i.e., pool resources and get a return on capital without paying a corporate tax on the gain).

If it makes certain distributions, a RIC is taxed only on the undistributed portion of its:
- ordinary income at the regular corporate tax rates; and
- net long-term capital gains at the corporate capital gains rate.

The RIC is not taxed on the amounts it distributes to shareholders through the mechanism of being allowed a dividends-paid deduction for dividends paid to shareholders. Other rules under the federal statutes governing the taxation of RICs generally preserve the character of the RIC's income in the dividends paid to shareholders. As a result, a RIC is able to pass through ordinary income, net capital gains, and certain other items to the shareholders without any tax at the RIC level.

Ordinary dividends that a RIC distributes to its shareholders are taxed to them just like other corporate dividends. Corporate shareholders of the RIC are allowed a deduction for dividends received. However, that deduction is allowed only to the extent that the RIC itself received dividends from corporate payors with respect to stock held in the RIC’s portfolio. Shareholders of the RIC are not entitled to a dividends received deduction with respect to amounts treated as capital gain dividends.

A REIT is taxed only on amounts not distributed to its shareholders, as follows:
- at regular corporate tax rates on undistributed earnings and profits and net capital gains; and
- at the highest corporate tax rate on net income from foreclosure property.

Like a RIC, the REIT is allowed a dividends-paid deduction for amounts paid to its shareholders as dividends, so the REIT in effect isn't taxed on the amounts it distributes to shareholders. Again, specific statutory rules under the REIT taxing statutes generally preserve the character of the REIT's income in the dividends paid to shareholders, thus effectively allowing it to pass through its earnings and profits, net capital gains, and net income from foreclosure property to the shareholders without any tax at the REIT level.

A dividend received from a REIT by a corporate shareholder of that REIT is not considered a dividend for purposes of the dividends received deduction.

Current State Law

California conforms, with certain modifications, to Subchapter M of the Internal Revenue Code, relating to RICs and Real Estate Investment Trusts (REITS).

California conforms to the federal treatment of a RIC except that the undistributed portion of net long-term gains are not treated as capital gains but instead are treated as ordinary income and are taxed at the regular corporate rate. Also, a modification was made to substitute the state code section reference relating to the dividends received deduction for the federal code section reference to reflect that California difference.

California conforms to the federal treatment of a REIT except that the undistributed portion of net long-term gains and foreclosure property, instead of being subjected to a separate excise tax as under federal law, are treated the same as other ordinary income realized by the REIT and are taxed at the regular corporate rate. In addition, a modification was made to substitute the state code section references relating to dividends received by corporate beneficiaries for the federal code section reference relating to the dividends received deduction.

With respect to an affiliated group of corporations engaged in a unitary business, California requires that the dividend be eliminated from the income of the recipient when one of the corporations pays a dividend out of its share of the unitary income to its parent corporation that is also a member of the unitary group (Revenue and Taxation Code (R&TC) Section 25106). The State Board of Equalization (SBE) has explained that the purpose of R&TC Section 25106 is to prevent double taxation for formula apportionment purposes. (See *Appeal of CTI Holdings, Inc.*, 96-SBE-003 (February 22, 1996).)

Problem

Some banks are taking the position that the interest income on their loan portfolio disappears from the California tax base when they utilize a RIC structure. That is, through friendly intermediaries and through a series of transactions, some banks have established wholly-owned shell corporations to which the bank then contributes a portfolio of loans that it has made to third-party customers in exchange for shares in that subsidiary. The bank then registers the subsidiary with the SEC as a RIC. Thereafter, when the RIC subsidiary receives interest payments on the loan portfolio, it pays all of the interest income to the bank as a RIC dividend and claims a deduction for the amount of the dividend under the RIC rules.

Based upon this structure, the bank then takes the position that:

- the RIC subsidiary has no net income that would be subject to California tax because the dividends paid by the RIC are tax deductible; and
- dividends received by the bank from the RIC subsidiary are eliminated under R&TC Section 25106 as a dividend paid to a parent corporation that is unitary with its subsidiary.

The banks justify this result through a comparison of the language in R&TC Section 24872(h), relating to REITs, and R&TC Section 24871(e), relating to RICs, since both sections deal with California modifications to the federal provisions relating to restrictions applicable to dividends received from REITs and RICs.

Proposed Solution

Amend R&TC Section 24871 subdivision (e) to add references to R&TC Sections 24406, 24410, and 25106 in addition to the reference to R&TC Section 24402 currently contained in that section. This change explicitly provides that dividends paid by a RIC to California corporate shareholders may not obtain the benefit of the exclusion from income under R&TC Section 25106 except for dividends received by the RIC from corporations that are unitary. Include "no inference" language so there will be no negative impact on current audits involving this issue.

Effective/Operative Date of Solution

This proposal, as a tax levy, if enacted during 2003, would be operative for taxable years beginning on or after January 1, 2003.

Justification

The purpose of R&TC Section 25106 is to ensure that income is not “double counted” in the taxable income of members of a unitary group. This section is not intended to allow income to be untaxed. Under this proposal the RIC would remain a pass-thru entity and would specify that a corporate distribution received from a RIC is taxable to the corporation receiving the distribution.

Implementation

The position taken by certain banks as discussed in this legislative proposal has created a significant audit and litigation workload for taxable years beginning before January 1, 2003. The proposal to clarify the law for taxable years beginning on or after January 1, 2003, to prevent these deductions would eliminate any additional workload.

Fiscal Impact

Departmental Costs

This proposal would specifically provide that taxpayers cannot take this deduction for taxable years beginning on or after January 1, 2003, and it would generate cost savings because audits and litigation would not be required in order to disallow the deduction.

Tax Revenue Estimate

The revenue effects of this proposal depend upon what is considered baseline. If baseline were that a technical statutory loophole exists (Taxpayers' Position, below), this proposal would generate substantial revenue gains annually. If baseline were that this proposal is declaratory of existing law, the proposal may still generate incremental revenue gains annually of an unknown, but lesser, magnitude.

This proposal could have the following revenue effects depending upon the correct interpretation.

Estimated Revenue Impact of LP03-14 Assumed Effective with Tax Years Beginning On or After 1/1/03 [$ In Millions]			
Interpretation of current law:	2003-04	2004-05	2005-06
Taxpayers' Position	$45	$55	$65
Department's Position	Unknown Minor Gains Annually		

Revenue Discussion

If a technical statutory loophole exists, the revenue impact of this proposal would be determined by the number of corporate taxpayers that set up RICs for purposes of deducting the same income twice, amounts of income deducted twice, and the tax rate of corporations that use the RIC structure to avoid tax. For taxpayers identified as using the RIC structure, the tax effects of deducting dividend income twice totals approximately $42.7 million for the 2000 taxable year. Absent this legislation, departmental staff believes use of the RIC structure to avoid tax will increase. Estimates above reflect an assumed 20% increase year over year.

Policy Considerations

The Securities and Exchange Commission (SEC) has indicated that it is considering withdrawing the registration of certain RICs. Revocation of registration would be for public policy purposes because the banks are transferring traditional banking activities to these RICs, and what they are doing apparently violates the intent of the 1940 Investment Company Act. In addition there is a question as to whether there is a valid transfer to the RIC as the bank is keeping the transfer "transparent" to its customers and retaining all control over the loan portfolios. This proposal would prevent the banks from treating the distributions from RICs as dividends for taxable years beginning on or after January 1, 2003, while legislative intent language would allow the taxpayers previously taking this deduction to litigate the department's denial of this deduction for taxable years beginning before January 1, 2003.

Agency/Industry Pro & Con Arguments

The SEC as well as some banks will support this proposal because they believe that the use of the RIC structure in this manner is improper.

The banks making use of this RIC structure will oppose this change. They argue that R&TC section 24872 subdivision (h) explicitly provides that dividends paid by REITs to California corporate shareholders may not obtain the benefit of the exclusion from income under Section 25106, whereas the statutory provision relating to RICs (R&TC Section 24871(e)) explicitly negates the application of only Section 24402. The banks, thus, take the position that dividends received from the RIC subsidiary are excluded from the bank's taxable income pursuant to R&TC Section 25106.

Other States

The following states were examined because of their similarity to California's economic activity:

Florida starts with federal taxable income, adds to that figure retained capital gain income of a RIC and subtracts dividends received from foreign (non-U.S.) corporations to arrive at "adjusted federal income" subject to apportionment. In the case of consolidated returns, the same procedures, including all inter-company adjustments and eliminations as used for federal purposes, are followed.

Illinois has adopted federal law as currently amended as the starting point for computing Illinois taxable income. Therefore, most corporations begin the computation with federal taxable income and make adjustments to arrive at Illinois base income. The Illinois base income of a RIC is federal taxable income plus any undistributed net long-term capital gain. Illinois requires "financial organizations," including a corporation that is owned by a bank, to use a single-factor gross receipts formula to apportion its business income. Corporations that are members of the same unitary business group must be treated as one taxpayer in determining the group's income tax liability. Income and deductions arising from transactions between members of a unitary group are eliminated whenever necessary to avoid distortion of the group's income.

Massachusetts adopts the federal treatment of income from a RIC with certain modifications denying credits for undistributed capital gain and foreign tax credits. Combined returns are permitted for the purpose of computing the tax on net income. However, dividends from a RIC are not allowed to be part of the dividends received deduction of a corporation receiving a RIC distribution.

Michigan, in general, starts with federal taxable income, adds to that figure dividends and interest paid and subtracts dividends and interest received in order to determine the Michigan tax base subject to allocation and apportionment. However, a RIC is not subject to these adjustments. Therefore, a RIC is not required to add back to federal taxable income its interest income and dividends derived from obligations or securities of states other than Michigan, or to add back its dividends paid.

Further, a deduction may not be taken from federal taxable income for dividends received. A consolidated or combined return is allowed to be filed by an affiliated group of corporations that are Michigan taxpayers. That group must have a relationship with other members of the group that includes intercorporate transactions of a substantial nature. In addition, all members of the group must use the same apportionment formula.

New York imposes a corporate franchise tax on a RIC measured by the greater of its "entire net income" base, the minimum taxable income base, or the fixed dollar minimum. The "entire net income" of a RIC is federal taxable income with certain modifications. A RIC is permitted to deduct dividends paid to its shareholders in determining its federal taxable income. A corporate shareholder of a RIC is denied the deduction for dividends received if those dividends are received from a subsidiary.

LEGISLATIVE STAFF CONTACT

John Pavalasky
Franchise Tax Board
845-4335
John.Pavalasky@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
Brian.Putler@ftb.ca.gov

Analyst John Pavalasky
Telephone # 845-4335
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-14

AMENDMENT 1

SEC. __. Section 24871 of the Revenue and Taxation Code is amended to read:

24871. (a) (1) Section 852(b)(1) of the Internal Revenue Code, relating to imposition of tax on regulated investment companies, shall not apply.

(2) Every regulated investment company shall be subject to the taxes imposed under Chapter 2 (commencing with Section 23101) and Chapter 3 (commencing with Section 23501), except that its "net income" shall be equal to its "investment company income," as defined in subdivision (b).

(b) "Investment company income" means investment company taxable income, as defined in Section 852(b)(2) of the Internal Revenue Code, modified as follows:

(1) Section 852(b)(2)(A) of the Internal Revenue Code, relating to an exclusion for net capital gain, shall not apply.

(2) Section 852(b)(2)(B) of the Internal Revenue Code, relating to net operating losses, is modified to deny the deduction allowed under Sections 24416 and 24416.1, in lieu of denying the deduction allowed by Section 172 of the Internal Revenue Code.

(3) In lieu of the provision of Section 852(b)(2)(C) of the Internal Revenue Code, relating to special deductions for corporations, no deduction shall be allowed under ~~Section~~ Sections ~~24402,~~ 24402, 24406, 24410, and 25106.

(4) The deduction for dividends paid, under Section 852(b)(2)(D) of the Internal Revenue Code, is modified to allow capital gain dividends and exempt interest dividends (to the extent that interest is included in gross income under this part) to be included in the computation of the deduction.

(c) Section 852(b)(3)(A) of the Internal Revenue Code, relating to capital gains, shall not apply.

(d) Section 852(b)(5)(B) of the Internal Revenue Code, relating to treatment of exempt interest dividends by shareholders, shall not apply.

(e) Section 854 of the Internal Revenue Code, relating to limitations applicable to dividends received from regulated investment companies, is modified to refer to ~~Section~~ Sections ~~24402,~~ 24402, 24406, 24410, and 25106, in lieu of Section 243 of the Internal Revenue Code.

~~(f) The amendments made to this section by the act adding this subdivision shall be operative for taxable years beginning on or after January 1, 1993.~~

SEC. . (a) The amendments made to Section 24871 of the Revenue and Taxation Code by this act shall be applied to taxable years beginning on or after January 1, 2003.

(b) It is the intent of the Legislature that no inference be drawn in connection with any matter governed by Section 24871 of the Revenue and Taxation Code for any taxable year beginning before January 1, 2003, with respect to the amendments made to Section 24871 of the Revenue and Taxation Code by this act.

SEC. . This act provides for a tax levy within the meaning of Article IV of the Constitution and shall go into immediate effect.

LEGISLATIVE PROPOSAL 03-16
EXECUTIVE SUMMARY

- **Title:** Erroneous Refund Interest Computation Simplification And Conformity

- **Problem Statement:** The R&TC is internally inconsistent on the method of calculating interest on an erroneous refund.

- **Proposed Solution:** Amend three sections in the R&TC, to conform with federal law, so that the general method for calculating interest on an erroneous refund is that interest accrues from the date the refund is erroneously made--but interest must be abated for the period from the date the erroneous refund is made to 30 days after demand for repayment is made by FTB.

- **Major Concerns/Issues:** None.

- **Revenue:** This proposal would not make a significant change in the calculation of interest or impact on the state's income tax revenues.

2003 Departmental Legislative Proposal
LP 03-16

Title

Erroneous Refund Interest Computation Simplification

Introduction

The Revenue and Taxation Code (R&TC) has four separate sections providing for the general computation of interest on an erroneous refund. Although the methods of calculation vary among the sections, the result for any particular refund is generally the same. In addition, only one of the R&TC sections conforms to federal exceptions to abatement of interest on an erroneous refund. This proposal would assure that interest on erroneous refunds is calculated using just one method and in conformity to federal law.

Current Federal Law

The current federal law provides that if the Internal Revenue Service (IRS) issues an erroneous refund, that erroneous refund may be recovered by notice and demand or by suit in court. Interest on the amount due back from the taxpayer accrues, but upon receipt of repayment, it is abated for the period between the issuance of the erroneous refund and 30 days after the IRS sends notice and demand for repayment. Under federal law, interest is not abated if the taxpayer contributed to causing the erroneous refund or if the erroneous refund exceeds $50,000.

Current State Law

The most recently enacted section on erroneous refund interest generally conforms to the federal law on erroneous refunds using stand-alone language. That section assumes interest accrues on the erroneous refund from the date issued, but abates interest for the period between issuance of the erroneous refund and a date 30 days after the date repayment is demanded. This section conforms to the federal abatement exceptions where the taxpayer contributed to causing the erroneous refund or where the erroneous refund exceeds $50,000.

The other three erroneous refund provisions provide that interest begins accruing 30 days after repayment is demanded. In addition, these sections do not expressly require imposition of interest for the entire period the taxpayer had use of the erroneous refund where the taxpayer contributed to causing the erroneous refund or where the refund exceeds $50,000.

Problem

The R&TC is internally inconsistent on the method of calculating interest on an erroneous refund.

Proposed Solution

Amend three sections in the R&TC, to conform with federal law, so that the general method for calculating interest on an erroneous refund is that interest accrues from the date the refund is erroneously made--but interest must be abated for the period from the date the erroneous refund is made to 30 days after demand for repayment is made by FTB.

Effective/Operative Date of Solution

This proposal would be effective January 1, 2004.

Justification

This proposal would make the R&TC sections consistent with regard to the abatement of interest on erroneous refunds. In addition, this proposal would conform state law to federal law with respect to abatement of interest on erroneous refunds.

Implementation

The necessary revisions to forms would be done during the normal annual update.

Fiscal Impact

Departmental Costs

This proposal would not impact the department's costs.

Tax Revenue Estimate

Since this proposal would not make a substantive change to the calculation of interest, it would not impact the state's income tax revenues.

Other States

Illinois and *Michigan* follow the federal law on abatement of interest on erroneous refunds. *Massachusetts, Minnesota* and *New York* do not impose interest on erroneous refunds if repaid within 30 to 60 days of the request. If repayment is not received within the prescribed time, interest starts accruing on the first, day after the 30 to 60 day period expires. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

LEGISLATIVE STAFF CONTACT

Jane Tolman
Franchise Tax Board
845-6111
Jane Tolman@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
Brian.Putler@ftb.ca.gov

Analyst Jane Tolman
Telephone # 845-6111
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-16

AMENDMENT 1

Section 19120 of the Revenue and Taxation Code is amended to read:

19120. Any portion of any amount which has been erroneously refunded and which is recoverable by suit pursuant to Section 19411 shall bear interest at the adjusted annual rate established pursuant to Section 19521 from the date of the payment of the refund.
For abatement of interest, see subdivision (c) of Section 19104. ~~from the date that is 30 days after the Franchise Tax Board mails a notice and demand for repayment~~

AMENDMENT 2

Section 19368 of the Revenue and Taxation Code is amended to read:

19368. If the Franchise Tax Board makes or allows a refund or credit that it determines to be erroneous, in whole or in part, the amount erroneously made or allowed may be assessed and collected after notice and demand pursuant to Section 19051 (pertaining to mathematical errors), except that the rights of protest and appeal shall apply with respect to amounts assessable as deficiencies without regard to the running of any period of limitations provided else wherein this part. Notice and demand for repayment must be made within two years after the refund or credit was made or allowed, or during the period within which the Franchise Tax Board may mail a notice of proposed deficiency assessment, whichever period expires the later. ~~Interest on amounts erroneously made or allowed shall not accrue until 30 days from the date the Franchise Tax Board mails a notice and demand for repayment as provided by this section~~
For abatement of interest, see subdivision (c) of Section 19104.

AMENDMENT 3

Section 19411 of the Revenue and Taxation Code is amended to read:

19411. (a) The Franchise Tax Board may recover any refund or credit or any portion thereof which is erroneously made or allowed, together with interest at the adjusted annual rate established pursuant to Section 19521 ~~beginning 30 days after the board mails a notice and demand for repayment~~, in an action brought in a court of competent jurisdiction in the County of Sacramento in the name of the people of the State of California within whichever of the following periods expires the later:
~~(a)~~ (1) Two years after the refund or credit was made.
~~(b)~~ (2) During the period within which the Franchise Tax Board may mail a notice of proposed deficiency assessment.
For abatement of interest, see subdivision (c) of Section 19104.

LEGISLATIVE PROPOSAL 03-17
EXECUTIVE SUMMARY

- **Title:** Exempt Orgs/Application For Exemptions Or Amending Articles Of Incorporation

- **Problem Statement:** There is a conflict between the Corporations Code and the Revenue and Taxation Code (R&TC) that can prevent a suspended corporation from obtaining tax-exempt status. The Corporations Code provisions preclude a suspended corporation from either filing for tax-exempt status or amending its articles of incorporation to perfect its tax-exempt application, which actions the R&TC expressly permits.

- **Proposed Solution:** Amend the Corporation Code to permit a suspended corporation applying for tax-exempt status to amend its articles of incorporation to perfect its application.

- **Major Concerns/Issues:** None.

- **Revenue:** This proposal would not impact the state's income tax revenue.

2003 Departmental Legislative Proposal
LP 03-17

Title

Exempt Orgs/Application For Exemptions Or Amending Articles Of Incorporation

Introduction

This proposal would eliminate inconsistencies between the Corporations Code and the Revenue and Taxation Code (R&TC) regarding the ability of a suspended corporation to apply for tax-exempt status. In addition, this proposal would permit a suspended corporation to amend its articles of incorporation in order to qualify for tax exempt status.

Current Federal/State Law

There is no comparable federal law with regard to a suspended corporation filing for tax-exempt status.

Under the Corporations Code and the R&TC, the Secretary of State (SOS) may suspend the powers, rights, and privileges of a corporation if the entity fails to pay taxes or fails to file tax returns, annual returns, or certain other information returns.

The R&TC permits a corporation to file an application for tax exemption even if the status of the corporation is suspended. The R&TC also allows a suspended corporation to amend its articles of incorporation to perfect an application for exemption; however, the Corporations Code does not provide authority for a suspended corporation to amend its articles of incorporation, typically to correct required organizational recitals.

Problem

There is a conflict between the Corporations Code and the R&TC that can prevent a suspended corporation from obtaining tax exempt status. The Corporations Code provisions preclude a suspended corporation from either filing for tax exempt status or amending its articles of incorporation to perfect its tax exempt application, which actions the R&TC expressly permits.

Proposed Solution

Amend the Corporations Code to permit a suspended corporation applying for tax-exempt status to amend its articles of incorporation to perfect its application.

Effective/Operative Date of Solution

If enacted during the 2003 legislative session, this proposal would be effective and operative January 1, 2004.

Justification

This proposal would allow the Franchise Tax Board (FTB) and the SOS to the treat suspended corporations seeking tax-exempt status consistently thereby improving the customer service environment.

Implementation

Implementing this proposal would not significantly impact the department's programs and operations.

Fiscal Impact

Departmental Costs

This proposal would not impact the department's costs.

Tax Revenue Estimate

This proposal would not impact the state's income tax revenue.

Other States

Illinois, Massachusetts, Michigan, Minnesota and *New York* laws do not allow corporations to apply for tax-exempt status while the corporation is suspended. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

LEGISLATIVE STAFF CONTACT

Jane Tolman
Franchise Tax Board
845-6111
Jane.Tolman@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
Brian.Putler@ftb.ca.gov

Analyst Jane Tolman
Telephone # 845-6111
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-17

AMENDMENT 1

Section 2205 of the Corporations Code is amended to read:

2205. (a) A corporation that (1) fails to file a statement pursuant to Section 1502 for an applicable filing period, (2) has not filed a statement pursuant to Section 1502 during the preceding 24 months, and (3) was certified for penalty pursuant to Section 2204 for the same filing period, shall be subject to suspension pursuant to this section rather than to penalty pursuant to Section 2204.

(b) When subdivision (a) is applicable, the Secretary of State shall mail a notice to the corporation informing the corporation that its corporate powers, rights, and privileges will be suspended after 60 days if it fails to file a statement pursuant to Section 1502.

(c) After the expiration of the 60-day period without any statement filed pursuant to Section 1502, the Secretary of State shall notify the Franchise Tax Board of the suspension, and mail a notice of the suspension to the corporation and thereupon, except for the ~~purpose of~~ filing an application for exempt status or amending the articles of incorporation as necessary to perfect that application or to set forth a new name, the corporate powers, rights, and privileges of the corporation are suspended.

(d) A statement pursuant to Section 1502 may be filed notwithstanding suspension of the corporate powers, rights, and privileges pursuant to this section or Section ~~23301 or 23301.5~~ 23301, 23301.5, or 23775 of the Revenue and Taxation Code. Upon the filing of a statement pursuant to Section 1502 by a corporation that has suffered suspension pursuant to this section, the Secretary of State shall certify that fact to the Franchise Tax Board and the corporation may thereupon be relieved from suspension unless the corporation is held in suspension by the Franchise Tax Board by reason of Section ~~23301 or 23301.5~~ 23301, 23301.5, or 23775 of the Revenue and Taxation Code.

AMENDMENT 2

Section 5008.6 of the Corporations Code is amended to read:

5008.6. (a) A corporation that (1) fails to file a statement pursuant to Section 6210, 8210, or 9660 for an applicable filing period, (2) has not filed a statement pursuant to Section 6210, 8210, or 9660 during the preceding 24 months, and (3) was certified for penalty pursuant to Section 6810, 8810, or 9690 for the same filing period, shall be subject to suspension pursuant to this section rather than to penalty under Section 6810 or 8810.

(b) When subdivision (a) is applicable, the Secretary of State shall mail a notice to the corporation informing the corporation that its corporate powers, rights, and privileges will be suspended 60 days from the date of the notice if the corporation does not file the statement required by Section 6210, 8210, or 9660.

(c) If the 60-day period expires without the delinquent corporation filing the required statement, the Secretary of State shall notify the Franchise Tax Board of the suspension, and mail a notice of the suspension to the corporation. Thereupon, except for the ~~purpose of amending the articles of incorporation~~ purposes of filing an application for exempt status or amending the articles of incorporation as necessary either to perfect that application or to set forth a new ~~name or filing an application for exempt status,~~ name, the corporate powers, rights, and privileges of the corporation are suspended.

(d) A statement required by Section 6210, 8210, or 9660 may be filed, notwithstanding suspension of the corporate powers, rights, and privileges under this section or under provisions of the Revenue and Taxation Code. Upon the filing of a statement under Section 6210, 8210, or 9660, by a corporation that has suffered suspension under this section, the Secretary of State shall certify that fact to the Franchise Tax Board and the corporation may thereupon be relieved from suspension, unless the corporation is held in suspension by the Franchise Tax Board because of Section 23301, 23301.5, or 23775 of the Revenue and Taxation Code.

LEGISLATIVE PROPOSAL 03-22
EXECUTIVE SUMMARY

- **Title:** Clarify Coordination of U.S.-Source Income & Subpart F Water's-Edge Partial Inclusion

- **Background:** AB 1469 (Ortiz, 1997/1998) contained proposed amendments to existing water's-edge provisions to address the first problem described in this proposal. Industry opposed the water's-edge provision and Governor Wilson vetoed AB 1469 because of it. However, reconsideration of this issue is warranted in light of the State's current fiscal crisis. There are indications that taxpayers may be beginning to incorporate their Controlled Foreign Corporations (CFCs) in an attempt to avoid inclusion of their Subpart F income in the apportionable base.

- **Problem Statement:** This proposal addresses two problems. First, there is an ambiguity in the law regarding whether a CFC that is a California taxpayer must be partially included in the water's-edge combined report. Second, unlike federal law, the water's edge statute does not coordinate the U.S.-source income and Subpart F rules for an item of income that qualifies under both rules. Some taxpayers have argued that the lack of coordination between the rules allows Subpart F income to escape taxation.

- **Proposed Solution:** Clarify that existing law does not allow a foreign corporation to become a California taxpayer, or have income from a U.S. source, and consequently exclude their Subpart F income from a water's-edge combined report. Also, coordinate the U.S.-source income and the Subpart F income rules to operate simultaneously. Thus, like federal law, 100% of the corporation's income that is U.S.-source and 100% of its Subpart F would be considered in the combined report for California tax purposes. Allow FTB to prescribe regulations to prevent the double counting of such income.

- **Major Concerns/Issues:** This proposal may be opposed as a tax increase. Opponents will argue that they have been allowed to either qualify as a foreign-affiliate or create sufficient nexus for that affiliate to cause their CFCs to become California taxpayers and thereby exclude Subpart F income. Alternatively, opponents may argue that the mere presence of U.S. source income would prevent the application of the Subpart F rules.

- **Revenue:** If this proposal simply clarifies the application of admittedly awkward provisions, there would be no revenue impact. If taxpayers are successful in arguing that Subpart F income should not be taxed, the total Subpart F income revenue of approximately $50 annually could be at risk.

2003 Departmental Legislative Proposal
LP 03-22

Title

Clarify Coordination of U.S.-Source Income & Subpart F Water's-Edge Partial Inclusion

Introduction

This proposal would make the following changes regarding Subpart F and US-source income:

- eliminate possible manipulation of the current rules relating to the Subpart F income of controlled foreign corporations;
- coordinate existing laws so that the U.S.-source income rules and the Subpart F income rules would operate simultaneously and apply consistently to corporations regardless of whether they are California taxpayers; and
- permit the Franchise Tax Board (FTB) to issue regulations to resolve problems relating to potential double taxation of U.S.-source and Subpart F income.

Background/Legislative History

AB 1469 (Ortiz, 1997/1998) contained proposed amendments to existing water's-edge provisions to address the first problem described in this proposal. Governor Wilson vetoed AB 1469 because of the water's-edge provision. In his veto message, Governor Wilson stated that he vetoed the bill because the water's-edge provision was added to the bill late in the legislative session with little or no policy debate, it could have a negative effect on the California business community, and it had the potential to result in a tax increase.

The department's analysis of AB 1469 described the proposed amendments contained in AB 1469 as addressing a potential interpretation of existing law that would allow taxpayers to pay the minimum franchise tax and avoid including Subpart F income in the combined report. Department staff assigned no revenue gain to the bill since, at that time, no taxpayer had been identified as filing in a manner to avoid including Subpart F income within the water's-edge apportionable income base. Analyses of AB 1469 by legislative staff indicated that the proposed amendments addressed an unintended "loophole" in existing law. Opponents who sought the bill's veto asserted that existing law represented an agreed-upon compromise when the water's-edge election was adopted and that amendment would change their filing position.

Current Federal Law

To understand this proposal it is necessary to understand the general federal rules for taxing corporations. Under current federal law, corporations organized in the U.S. are taxed on all their income, regardless of source and are allowed a credit for any taxes paid to a foreign country on their foreign source income.

Foreign corporations engaged in a U.S. trade or business are taxed applying U.S. graduated corporate income tax rates on the net income effectively connected with the conduct of that business in the U.S. This is known as effectively connected income, or ECI. In addition, foreign corporations are taxed at a flat 30% rate (or lower rate if provided by treaty) on specified types of fixed, determinable, annual, or periodic income (usually investment income) from U.S. sources. The income of a foreign corporation can be composed of either U.S.-source income or foreign-source income.

This proposal deals with how the income of Controlled foreign corporations (CFCs) is taxed. CFCs that are not engaged in a U.S. trade or business can have a type of income known as Subpart F income. This income is treated as being paid to the U.S. shareholders as a dividend immediately upon being earned, which allows the U.S. to immediately tax certain “tax haven income” when the CFC earns it and prevents deferral of tax.

A foreign corporation can be engaged in a U.S. trade or business, or hold securities issued by a U.S. corporation, and be a "CFC" and, therefore, have both U.S.-source and Subpart F income. In addition, some items of income can qualify both as U.S.-source and Subpart F income. To the extent that a foreign corporation has an item of income that is both, it generally will be subject to both the U.S.-source rules and the Subpart F income rules. Thus, U.S.-source income is taxed under U.S. sourcing rules and foreign-source income is taxed under the Subpart F income rules.

It is important to note that effectively, 100% of the foreign corporation’s income that meets the definitions of ECI and Subpart F rules is taxed. This is accomplished because the federal statutes coordinate the U.S.-source and Subpart F income rules so that both sets of rules operate simultaneously and apply to a single corporation, but the same item of income is taxed only once.

Current State Law

Under current California law, California source income for corporations that operate both within and without the state is determined on a worldwide basis using the unitary method of taxation. Under the unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of that income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales.

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine their income on a "water's-edge" basis. Generally, under water’s-edge an entity incorporated in the U.S. is included in the combined report while a foreign entity is excluded. The following rules apply for determining if an entity is included or excluded from the combined report under water’s-edge.

- U.S. entities and certain corporations that receive special treatment for federal tax purposes, such as Domestic International Sales Corporations (DISCs) and Foreign Sales Corporations (FSCs), are included in the water’s-edge group.

- Any foreign incorporated entity, excluding banks, that has 20% or more of its business in the U.S., based on its average property, payroll, and sales, is included in the water’s-edge group.

- Possessions corporations (U.S. incorporated entities located in U.S. possessions, most notably Puerto Rico, which for federal tax purposes have elected the benefits of Internal Revenue Code Section 936) generally are not included in the water's-edge group.

- Foreign corporations with less than 20% of their activities in the U.S. and foreign banks are included in the water's-edge combined report but only to the extent of their U.S.-source income.

- Any affiliated corporation that is a CFC for federal tax purposes is partially included in the water's-edge combined report. In general, the income and apportionment factors of the CFC are included based on the ratio of the CFC's Subpart F income for federal purposes for the current year to the CFC's earnings and profits (E&P) for the current year. The ratio can be 0% or higher. However, it cannot exceed 100%.

This proposal deals with two problems in current state law regarding the taxation of CFCs. First, there is an ambiguity that could result in manipulation of the current rules relating to inclusion of CFC's in the water's-edge group. Generally, CFCs are not California taxpayers. However, a water's-edge group could cause its CFC to become a California taxpayer by either qualifying with the Secretary of State or establishing minimal ties in California sufficient to create nexus and a minimum tax liability. While department staff has consistently interpreted the statute to require any CFC to be partially included in the water's-edge combined report[1], some in industry have argued that if a CFC is a California taxpayer, the income is limited to its U.S.-source income. Thus, industry has argued that such a CFC should pay only the $800 minimum franchise tax and exclude its Subpart F income from the water's-edge combined report.

Alternatively, a CFC might hold stock or a debt instrument of a U.S. corporation, treated under federal law as U.S.-source income. Taxpayers have argued that even a small amount of U.S.-income causes its included income in the combined report to be limited under Revenue and Taxation Code (RTC) Section 25110(a)(4) "to the extent of" its U.S. source income and apportionment factors. See Appendix I for additional information about this ambiguity.

Second, current law does not specify whether the U.S.-source income rules or the Subpart F income rules are applied to income of a CFC that qualifies as both U.S.-source income and Subpart F income. However, California Code of Regulations Section 25110(d)(2)(H) provides that the U.S.-source income rules apply when both rules could apply. If the same income item were both Subpart F income and U.S.-source income, the regulation would treat that *item* of income as U.S.-source income rather than Subpart F income.

Since the U.S.-source and Subpart F rules are not coordinated as they are under federal law, some taxpayers have argued that California law and the regulation provide that if a CFC has an item of U.S.-source income and a separate item of Subpart F income, that the U.S.-source income causes the Subpart F rules to no longer apply and the Subpart F income escapes taxation.

---

[1] It is department staff's opinion that the provisions of Section 25110(a)(6), which include "any" affiliated CFC, is broad enough to require inclusion of all CFCs in the combined report, regardless of whether they are California taxpayers. Further, the rules of statutory construction would favor the inclusion of CFCs because presumably the legislature would not create a law including CFCs in the water's-edge group that could be avoided simply by becoming a California taxpayer or generating a minimal amount of U.S. source income.

For example, a CFC had a total net income of $4 million. Of the $4 million, $200,000 is U.S.-source income and $3 million is Subpart F income. Assume that the $200,000 U.S.-source income also qualifies as Subpart F income. Taxpayers have argued that the Subpart F income rules would not apply and only the $200,000 U.S.-source income would be included in the water's-edge combined report. Department staff has interpreted the law and regulation to work to prevent double taxation of the income so that $2,800,000 ($3 million Subpart F income less the amount included under the U.S.-source income rules) would be included under the Subpart F rules and $200,000 would be included under the U.S.-source rules.

Problem

This proposal addresses two problems:

First, there is an ambiguity in the law regarding whether a CFC that is a California taxpayer must be partially included in the water's-edge combined report.

Second, unlike federal law, the water's-edge statute does not coordinate the U.S.-source income and Subpart F rules for an item of income that qualifies under both rules. Taxpayers have argued that the lack of coordination between the rules allows the Subpart F income to escape taxation.

Proposed Solution

Amend RTC Section 25110. Clarify that existing law does not allow a foreign corporation to become a California taxpayer, or have income from a U.S. source, and consequently exclude their Subpart F income from a water's-edge combined report.

In addition, coordinate the U.S.-source income and the Subpart F income rules to operate simultaneously. Thus, like federal law, 100% of the corporation's income that is U.S.-source and 100% of its Subpart F would be considered in the combined report for California tax purposes. The rules would apply regardless of whether the entity is a California taxpayer. In addition, add a requirement that FTB prescribe regulations to prevent the double counting of income and factors when a corporation has both U.S.-source and Subpart F income.

Effective/Operative Date of Solution

If enacted in the 2003 legislative session as a tax levy, this proposal would apply to taxable years beginning on or after January 1, 2003.

Justification

This proposal would clarify existing law, eliminate taxpayer confusion, and eliminate unintended opportunities for tax avoidance.

In 1986, when defining the water's-edge group, the federal working group (which included legislative, government, and corporate participants) agreed that an effort should be made to (1) maintain a water's-edge group that was at least congruent with the federal consolidated return, and (2) include those activities and income which were generally recognized as tax-advantaged devices. An underlying principle was that to the extent possible, states should conform to the federal international taxation rules. This was generally to ensure that if the income of an entity was required to be taxed for federal purposes, then the income and factors of that entity should also be included in the state return. In addition, conformity with federal law reduces the taxpayer's compliance burden.

There is little rationale to justify circumventing the law requiring partial inclusion of a CFC, merely because that CFC member of the unitary group also has U.S. source income or is a California taxpayer.

Implementation

The proposal could be implemented in the department's annual program updates.

Fiscal Impact

Departmental Costs

No departmental costs are associated with this proposal.

Tax Revenue Estimate

If this proposal simply clarifies the application of admittedly awkward provisions, there would be no revenue impact. However, taxpayers assert that under their interpretation of existing law, they have been allowed since 1988 to create sufficient nexus for a foreign-affiliate to cause their CFCs to become California taxpayers and avoid including otherwise includible Subpart F income. The total revenue at risk is uncertain but could reach $50 million annually in the near future. This projection is based on a prior examination by audit staff of corporations with prominent CFCs. To date, very few taxpayers have been identified as asserting a nexus or other position for excluding otherwise includible Subpart F income.

Tax Revenue Discussion

Under the taxpayers' interpretation, the number of CFCs that establish ties in California sufficient to create nexus, and any otherwise includible Subpart F income and apportionment factors would determine the revenue impact of this proposal. Removing CFC dividends from the calculation of the inclusion ratio (used to determine includable Subpart F income) has been previously estimated, through an examination of tax returns, at $25 million annually. Departmental staff estimates that this loss is roughly half of the loss attributed to excluding all Subpart F income. Thus, the total revenue at risk could reach $50 million annually.

Policy Considerations

The underlying principle of the water's-edge legislation was to the extent possible, California should conform to the federal international taxation rules. Therefore, the U.S.-source income and Subpart F income partial inclusion rules should be coordinated to include all such income of a foreign corporation, regardless of whether that corporation is a taxpayer, in the California apportionable income base. This coordination is consistent with federal treatment.

Under the opponents' view, the legislature's addition of income and apportionment factors attributable to Subpart F income of a CFC to the water's-edge combined report would be nullified by relatively simple tax planning. If so, the Subpart F provisions would be effective only as a tax trap for the unwary.

Agency/Industry Pro & Con Arguments

Opponents may actively oppose this proposal. Opponents have contended that since the enactment of the water's-edge legislation they have been allowed either to qualify as a foreign-affiliate or to create sufficient nexus for that affiliate to cause a CFC to become a California taxpayer and thereby avoid the inclusion of Subpart F income. Under this interpretation, as a California taxpayer, the CFCs were liable for and paid only the $800 minimum corporation franchise tax and were not required to include Subpart F income within the water's-edge apportionable income base. Alternatively, taxpayers may argue that the mere presence of U.S. source income would prevent the application of the Subpart F partial inclusion rule. Thus, they would argue, this proposal results in a tax increase.

Other States

Other states have variations on the rules for apportionment of income of the activities of multinational corporations conducted in foreign countries. However, no other state taxes on a water's-edge basis similar to California. Thus, it does not appear that these issues apply to other states.

Additional Comments

- Previously, staff was only aware of a handful of taxpayers that were using the argument that their CFCs, although not incorporated in California, had nexus in California and were taxpayers in the year at issue and not required to include Subpart F income. Staff is now aware of a taxpayer that has actually incorporated its CFCs through the Secretary of State. This indicates that taxpayers may be beginning to incorporate their CFCs in California in an attempt to avoid inclusion of their Subpart F income in the apportionable base.

- Congress is currently reviewing federal international taxation rules because the FSC rules and their replacement, the "Extraterritorial Income (ETI)" rules, were held to be illegal under the "General Agreements on Tariffs and Trade (GATT)." Congress is currently determining how to tax international corporations to meet GATT and avoid being an illegal export subsidy.

  However, the status of the federal law does not directly impact this proposal. Under California law, FSCs are included 100% in a water's-edge return under RTC 25110(a)(1). The federal rules being reviewed apply to U.S. corporations that will be able to exclude income that qualifies as "extraterritorial income". U.S. corporations are 100% included under RTC 25110(a)(3). Thus, for California purposes the income is still included 100%. Department staff will continue to review any federal changes for impact to the water's-edge law.

LEGISLATIVE STAFF CONTACT

Marion Mann DeJong	Brian Putler
Franchise Tax Board	Franchise Tax Board
845-6978	845-6333
marion.dejong@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Marion Mann DeJong
Telephone # 845-6979
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-22

AMENDMENT 1

Section 25110 of the Revenue and Taxation Code is amended to read:

25110. (a) Notwithstanding Section 25101, a qualified taxpayer, as defined in paragraph (2) of subdivision (b), that is subject to the tax imposed under this part, may elect to determine its income derived from or attributable to sources within this state pursuant to a water's-edge election in accordance with the provisions of this part, as modified by this article. A taxpayer that makes a water' s-edge election shall take into account that portion of its own income and apportionment factors and the income and apportionment factors of its ~~the following~~ affiliated entities (if any) ~~only~~ to the extent provided below:

(1) The entire income and apportionment factors of the following corporations:

(A) Domestic international sales corporations, as described in Sections 991 to 994, inclusive, of the Internal Revenue Code and foreign sales corporations as described in Sections 921 to 927, inclusive, of the Internal Revenue Code.

~~(2)~~ (B) Any corporation (other than a bank), regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the United States is 20 percent or more.

~~(3)~~ (C) Corporations that are incorporated in the United States, excluding corporations making an election pursuant to Sections 931 to 936, inclusive, of the Internal Revenue Code~~, of which more than 50 percent of their voting stock is owned or controlled directly or indirectly by the same interests~~.

~~(4) A corporation that is not described in paragraphs (1) to (3), inclusive, or paragraph (5), but only to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3) of subdivision (b). Income of that corporation derived from or attributable to sources within the United States as determined by federal income tax laws shall be limited to and determined from the books of account maintained by the corporation with respect to its activities conducted within the United States.~~

~~(5)~~ (D) Export trade corporations, as described in Sections 970 to 972, inclusive, of the Internal Revenue Code.

(2) With respect to a corporation that is not described in subparagraphs (A), (B), or (C) of paragraph (1), as follows:

(A) The income and apportionment factors of such a corporation, to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3) of subdivision (b). Income of that corporation derived from or attributable to sources within the United States as determined by federal income tax laws shall be limited to and determined from the books of account maintained by the corporation with respect to its activities conducted within the United States.

(B) The income and apportionment factors of such a corporation that ~~(6) Any affiliated corporation which~~ is a "controlled foreign corporation," as defined in Section 957 of the Internal Revenue Code, ~~if all or part of the income of that affiliate is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income"). The income and apportionment factors of any affiliate to be included under this paragraph shall be~~ to the extent determined by multiplying the income and apportionment factors of that ~~affiliate without~~ corporation (without application of this ~~paragraph~~ subparagraph) by a fraction (not to exceed one), the numerator of which is the "Subpart F income" of that corporation for that taxable year and the denominator of which is the "earnings and profits" of that corporation for that taxable ~~year, as defined in Section 964 of the Internal Revenue Code.~~ year. For purposes of this subparagraph:

(i) “Subpart F income” means “subpart F income” within the meaning of Section 952 of the Internal Revenue Code.

(ii) “Earnings and profits” means “earnings and profits” within the meaning of Section 964 of the Internal Revenue Code.

(3) The income and apportionment factors of the corporations described in this subdivision shall be taken into account only to the extent that they would have been taken into account had no election been made under this section.

(4) The Franchise Tax Board shall prescribe regulations to coordinate the provisions of subparagraphs (A) and (B) of paragraph (2) to prevent multiple inclusion or exclusion of income and factors in situations where the same item of income is described in both subparagraphs.

~~(7)(A) The income and factors of the above-enumerated corporations shall be taken into account only if the income and factors would have been taken into account under Section 25101 if this section had not been enacted.~~

~~(B) The income and factors of a corporation that is not described in paragraphs (1) to (3), inclusive, and paragraph (5) and that is an electing taxpayer under this subdivision shall be taken into account in determining its income only to the extent set forth in paragraph (4).~~

(b) For purposes of this article and Section 24411:

(1) An "affiliated corporation" means a corporation that is a member of a commonly controlled group as defined in Section 25105.

(2) A "qualified taxpayer" means a corporation which does both of the following:

(A) Files with the state tax return on which the water's-edge election is made a consent to the taking of depositions at the time and place most reasonably convenient to all parties from key domestic corporate individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board as provided in Section 19504 or by the State Board of Equalization as provided in Title 18, California Code of Regulations, Section 5005, or by the courts of this state as provided in Chapter 2 (commencing with Section 1985) of Title 3 of Part 4 of, and Section 2025 of, the Code of Civil Procedure. The consent relates to issues of jurisdiction and service and does not waive any defenses a taxpayer may otherwise have. The consent shall remain in effect so long as the water's-edge election is in effect and shall be limited to providing that information necessary to review or to adjust income or deductions in a manner authorized under Sections 482, 861, Subpart F of Part III of Subchapter N, or similar provisions of the Internal Revenue Code, together with the regulations adopted pursuant to those provisions, and for the conduct of an investigation with respect to any unitary business in which the taxpayer may be involved.

(B) Agrees that for purposes of this article, dividends received by any corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) from either of the following are functionally related dividends and shall be presumed to be business income:

(i) A corporation of which more than 50 percent of the voting stock is owned, directly or indirectly, by members of the unitary group and which is engaged in the same general line of business.

(ii) Any corporation that is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or that sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. "Significant," as used in this subparagraph, means an amount of 15 percent or more of either input or output.

All other dividends shall be classified as business or nonbusiness income without regard to this subparagraph.

(3) The definitions and locations of property, payroll, and sales shall be determined under the laws and regulations that set forth the apportionment formulas used by the individual states to assign net income subject to taxes on or measured by net income in that state. If a state does not impose a tax on or measured by net income or does not have laws or regulations with respect to the assignment of property, payroll, and sales, the laws and regulations provided in Article 2 (commencing with Section 25120) shall apply.

Sales shall be considered to be made to a state only if the corporation making the sale may otherwise be subject to a tax on or measured by net income under the Constitution or laws of the United States, and shall not include sales made to a corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) in determining the amount of income of the taxpayer derived from or attributable to sources within this state.

(4) "The United States" means the 50 states of the United States and the District of Columbia.

(c) All references in this part to income determined pursuant to Section 25101 shall also mean income determined pursuant to this section.

Appendix I

A literal application of two different provisions of Revenue and Taxation Code Section 25110, subdivision (a)(6) and subdivision (a)(7)(B), yields two mutually inconsistent results. Under subdivision (a)(6), the income and factors of a Controlled Foreign Corporation (CFC) that is an affiliated corporation of a taxpayer that made a water's-edge election is included (to the extent of the Subpart F ratio) in the combined report of a taxpayer making a water's-edge election. Subdivision (a)(6), by its terms, applies regardless of whether the CFC is a taxpayer. Under subdivision (a)(7)(B), the income and factors of a CFC that is an electing taxpayer are included in the combined report for water's-edge purposes, but only to the extent of its income and factors attributable or assignable to U.S. sources, thereby arguably excluding Subpart F income from the income and factors of a water's-edge group.

As originally enacted in 1986 (operative for income years beginning on or after January 1, 1988), Section 25110(a)(7)(B) applied only to foreign banks and was included in the water's-edge legislation to clarify that a foreign bank would be included in a water's-edge combined report only to the extent of its U.S.-source income. Further, the ordering of the statute was such that the language of Section 25110(a)(7)(B) immediately followed the paragraph describing the U.S.-source income partial inclusion rules and before the paragraph describing the Subpart F income partial inclusion rules.

In 1988, the section was amended to change the term "bank" to "bank and corporation" so that if either a foreign bank or a foreign corporation had U.S.-source income, it could elect water's-edge and include income and factors in the combined report only to the extent of the U.S.-source income. In addition, the statute was renumbered so that Section 25110(a)(7)(B) now follows the paragraphs describing both the U.S.-source and the Subpart F partial inclusion rules.

A cardinal principle of statutory construction is to give effect to all of the provisions of a statute. Pursuant to the current provisions of Section 25110(a)(6), the income and factors of a CFC that is an affiliated corporation must be included to the extent of the Subpart F ratio within the combined report of a taxpayer making a water's-edge election. It is also clear that the provisions of subdivision (a), paragraphs (1) through (6) are limited to taxpayers with affiliated corporations. Subparagraph (7)(B), on the other hand, was enacted to permit a foreign taxpayer with no water's-edge affiliates to make a water's-edge election, taking into account its income and factors only to the extent of income derived from or attributable to sources within the U.S. and its factors assignable to a location in the U.S. Subparagraph (7)(B) was not intended to permit a CFC with Subpart F income to make an election and, for all practical and legal purposes, write the inclusion rules of paragraph (6) out of existence.

Nothing in the legislative record indicates intent to include CFCs to the extent of their Subpart F income while simultaneously allowing the same CFCs to shelter that income from inclusion in the combined report by becoming taxpayers.

LEGISLATIVE PROPOSAL 03-23
EXECUTIVE SUMMARY

- **Title:** Controlled Foreign Corporations (CFCs) in Water's-Edge Combined Report

- **Problem Statement:** The complexity associated with partially including the income and apportionment factors of CFCs in the income and apportionment factors of the water's-edge group is extremely burdensome for taxpayers and overshadows the tax policy goal of currently taxing "tax haven income."

- **Proposed Solution:** Eliminate the complex CFC partial inclusion rules by changing the conceptual approach of California's method of including a CFC's income to more closely conform to the federal method. Including Subpart F deemed dividends in the gross income of a U.S. shareholder that is a member of a water's-edge group rather than partially including the CFC in the water's-edge group would accomplish this simplification. In addition, the apportionment factors of the CFC would no longer be included in the apportionment factors of the water's-edge group.

- **Revenue:** The net revenue impact of this proposal is unknown due to a lack of data. Because there would be winners and losers under the proposal, the net revenue impact likely would be revenue neutral in any given year. The unknown revenue impact may make it difficult to find an author.

2003 Departmental Legislative Proposal
LP 03-23

Title

Controlled Foreign Corporations in Water's-Edge Combined Report

Introduction

This proposal would eliminate a complex area of law for taxpayers making water's-edge elections by changing the conceptual approach of California's method for including a controlled foreign corporation's tax haven income in the calculation of California income.

Current Federal Law

To understand this proposal it is necessary to understand the general federal rules for taxing corporations. Under current federal law, corporations organized in the U.S. are taxed on all their income, regardless of source. U.S. organized corporations are allowed at their option either a credit or a deduction for taxes paid to a foreign country on income earned from a foreign source because it is taxed by both the U.S. and the foreign country.

Foreign corporations engaged in a U.S. trade or business are taxed by applying U.S. graduated corporate income tax rates on the net income effectively connected with the conduct of that trade or business in the U.S. In addition, foreign corporations are taxed at a flat 30% rate (or a lower rate if provided by treaty) on specified types of fixed, determinable, annual or periodic income, usually investment income, from U.S. sources.

This proposal deals with controlled foreign corporations (CFCs). Foreign corporations owned by certain U.S. shareholders are described as "CFCs," and may engage in certain activities that are viewed as "tax haven" activities because the activities are conducted in a foreign jurisdiction that has a substantially lower tax rate than the U.S. This has the effect of shifting income from the U.S. taxing jurisdiction to a tax haven jurisdiction. Income earned by CFCs from these activities is called "Subpart F income." Until the enactment of Subpart F, the income earned in a tax haven country could not be taxed until it was paid to a U.S. shareholder in the form of a dividend. Thus, such income could be indefinitely deferred for U.S. tax purposes if the controlling parent corporation (a U.S. shareholder) directed its subsidiary not to pay dividends. A primary objective of the federal Subpart F provisions is to reduce the incentive for taxpayers to locate investments or income through tax planning in a low-tax foreign jurisdiction solely for reasons of tax deferral or tax avoidance. Subpart F accomplishes this objective by treating income of a CFC as dividends paid and taxable to U.S. shareholders at the time the income was earned by the CFC, regardless of whether a dividend is actually declared. This type of constructive dividend is referred to as a "Subpart F deemed dividend."

Actual dividends later paid by a CFC to U.S. shareholders are not included in income and thus not taxed to the extent that they are paid from earnings that have previously been taxed as Subpart F deemed dividends (known as "previously taxed income").

Current State Law

Under California law, corporations deriving income from sources both within and outside California are required to measure their tax liability by reference to their income derived from or attributable to sources within California. To determine the portion of total income that is attributable to California, the apportionment and allocation method is used. In addition, under California law, all affiliated entities comprising a single trade or business are viewed as a whole, wherever they may be doing business. The members of such a single trade or business are collectively called a “unitary group.” The business income of all the affiliates that comprise a unitary group is reported to California on a single report known as the “combined report.” The apportionment method uses a formula to calculate the amount of a unitary group’s total income that was generated from the unitary group’s activities in California. This formula is comprised of three component factors that measure the activity of a unitary group in the state: property, payroll, and sales, with the sales factor normally double weighted. The unitary group’s California business income is then apportioned among the members that are taxable in California, but each member retains a separate tax identity and liability.

California law allows a unitary group to elect the option of calculating its California income and activities on a water’s-edge basis in lieu of combining on a worldwide basis. The problem framed by this Legislative Proposal is concerned only with the election to calculate income and activities on a water's-edge basis.

Water's-edge electors generally can exclude foreign-organized affiliated entities that are otherwise part of a unitary group from the combined report. However, the water’s edge rules require that the income and apportionment factors of certain foreign-organized affiliated entities, including CFCs, be included, all or partially, in the apportionable income and apportionment factors of the water's-edge group.

The amount of a CFC’s income required to be included in the water’s-edge calculation of tax is determined using a complex formula known as the partial inclusion rules. The formula is the ratio of the CFC's income that is considered Subpart F income for federal purposes to the CFC's earnings and profits for federal purposes. The CFC includes all of its Subpart F income in the numerator of the inclusion ratio for purposes of the water’s-edge combined report, even if members of the unitary group hold less than 100% of its stock. The CFC partial inclusion rules were added to the initial water’s-edge legislation to address concerns regarding “tax haven income.”

Current Practice

Department staff has found low compliance with the CFC partial inclusion rules. When calculating includable income for a CFC, many taxpayers simply use the federal “deemed Subpart F dividends,” as reported on their federal return, rather than using the inclusion ratio formula to determine the amount of income to be included.

For unitary taxpayers, the California computation may only be material for some, but not all, affiliated CFCs. Even so, compliance with the law requires all unitary taxpayers to perform the recordkeeping and analysis for each of their CFCs, regardless of whether the result materially affects California tax. This requirement is particularly burdensome for taxpayers that do not have a large presence in California since the computations in the partial inclusion ratio are unique to California.

The CFC partial inclusion rules are also burdensome for the department to administer. Department auditors spend numerous hours verifying the calculations for the inclusion ratios only to discover that the adjustments have minor tax effect. That is because modifying the inclusion ratios can increase the amount of dividends excluded from income or because the taxpayer included the federal deemed Subpart F dividend amount in income, which sometimes results in almost the same tax amount.

Partial inclusion of Subpart F entities also produces complexities with respect to the application of other provisions of law (e.g., dividend elimination between members of a combined reporting group, foreign investment interest offset, and intercompany transactions).

Problem

The complexity associated with partially including the income and apportionment factors of CFCs in the income and apportionment factors of the water's-edge group is extremely burdensome for taxpayers and overshadows the tax policy goal of currently taxing "tax haven income."

Proposed Solution

Eliminate the complex CFC partial inclusion rules by changing the conceptual approach of California's method of including a CFC's income to more closely conform to the federal method. Including Subpart F deemed dividends in the gross income of a U.S. shareholder that is a member of a water's-edge group rather than partially including the CFC in the water's-edge group would accomplish this simplification. In addition, the apportionment factors of the CFC would no longer be included in the apportionment factors of the water's-edge group.

The determination of whether the Subpart F deemed dividend would be included in income apportionable to California would depend on how an actual dividend received from the CFC would be treated. If an actual dividend would be business income, it would be included in the income of the unitary group and apportioned. If an actual dividend would be nonbusiness income, it would be allocated to the corporate shareholder's commercial domicile.

As under federal law, actual dividends received from the CFC would be excluded from income to the extent attributable to amounts previously included in income. This exclusion would apply even if the shareholder were no longer filing on a water's-edge basis when it receives the distribution. In addition, the shareholder's basis in the CFC stock would be increased by Subpart F income and decreased by dividends paid from previously taxed income.
Conformity to federal treatment would take into account only the CFC's income attributable to U.S. shareholders that are included in the water's-edge group, based on the percentage of ownership of the CFC's stock. Thus, a smaller amount of the Subpart F income might be taken into account than under current law. However this effect is mitigated because the apportionment factors of the CFC (mostly in the denominator of the water's-edge group's apportionment factors) would not be considered in the water's-edge combined report.

The rationale behind including "tax haven" income in the tax base is that it represents income that would have been taxed to a U.S. shareholder if the income had been earned directly rather than shifted to a low-tax jurisdiction, where taxation can be deferred indefinitely. To maintain the policy of including the "tax haven income" in the tax base, the foreign dividend deduction would not apply to Subpart F deemed dividends.

This proposal would provide transition rules to allow taxpayers filing under existing water's-edge contracts to continue the partial inclusion of the CFC until the expiration of the contract period or elect to use these new Subpart F deemed dividend rules throughout the remainder of their contract period. Once an existing water's-edge contract expires, or seven years from the date this proposal is enacted, the taxpayer group must use the Subpart F deemed dividend rules if it continues to file on a water's-edge basis.

Effective/Operative Date of Solution

If this proposal were enacted as a tax levy during the 2003 legislative session, it would be effective upon enactment and operative for taxable years beginning on or after January 1, 2003. However, the proposal provides that it would apply only to taxpayers making a new water's-edge election for taxable years beginning on or after January 1, 2003. Rules would be provided for taxpayers with a current water's-edge election in effect to allow them to elect to use the deemed Subpart F dividend rules in lieu of the partial inclusion of the CFC. The new rules would be mandated for all taxpayers for all taxable years beginning on or after January 1, 2010.

Justification

This proposal would accomplish the original goal of the CFC partial inclusion rules by including tax haven income in the water's-edge combined report. However, this proposal would accomplish that goal by a much simpler means. The complex computations associated with the CFC partial inclusion rules would be eliminated. Taxpayers could use the federal Subpart F deemed dividend amount for state purposes.

Implementation

Implementing this proposal would require some changes to existing tax forms and instructions, which could be accomplished during the normal annual update. Regulations would be needed to address transition issues and issues for taxpayers moving from worldwide to water's-edge or vice versa.

Fiscal Impact

Departmental Costs

This proposal would not significantly impact the department's costs.

Tax Revenue Estimate

The net revenue impact of this proposal is unknown due to a lack of data. Based on limited data and assumptions discussed below, the net revenue impact likely would be roughly revenue neutral in any given year. There would be winners and losers under the proposal. If the impact could be quantified, the full effect would be out several years as there would be a transitional period during which current water's-edge electors would be allowed to report under current rules until the taxpayer's contract period expires.

Tax Revenue Discussion

The revenue impact of this proposal would be determined by the difference in amounts of net CFC income (under current state rules) and deemed dividend distributions (under federal rules).

There are roughly 6,900 domestic and foreign parent corporations that have elected water's-edge combined reporting. Approximately 15% are U.S. domestic corporations. Thus, approximately 1,000 electors potentially have CFCs with Subpart F income. Of the 1,000 taxpayers, about 40% already report the federal deemed dividend amounts erroneously due to misunderstanding the complexities of existing state law. The other 60% attempt to compute amounts required under California law but generally are unsuccessful due to various errors. Most audit assessments relative to this issue have been issued to taxpayers that have attempted to properly report California income. Errors are the result of the many complexities associated with partial inclusion of an entity in a combined report.

Departmental staff who specialize in water's-edge combined reporting strongly believe that about 80% of the approximate 1,000 taxpayers would be clustered around revenue neutrality in any given year under state or federal rules. Of the remaining 20% of taxpayers (about 200), staff estimates that, for most, any audit adjustments would not be particularly significant. Therefore, relatively few corporations would be either a significant winner or loser under this proposal with the greater likelihood that more taxpayers would be disadvantaged.

Policy Considerations

There does not appear to be any overwhelming policy reason for maintaining the current CFC partial inclusion rules that justifies the complexity of those rules when a simpler method could be used to address the treatment of "tax haven income." This proposal would continue the tax policy of including "tax haven income" in the water's-edge combined report, but with a simpler method. Conformity with federal law would also significantly reduce the taxpayer's compliance burden.

Agency/Industry Pro & Con Arguments

In 1986, when defining the water's-edge group, the federal working group (which included legislative, government, and corporate participants) agreed that an effort should be made to (1) maintain a water's-edge group that was at least congruent with the federal consolidated return, and (2) include those activities and income which were generally recognized as tax-advantaged devices. An underlying principle was that to the extent possible, states should conform to the federal international taxation rules. This was generally to ensure that if the income of an entity was required to be taxed for federal purposes then the income and factors of that entity should also be included in the state return. In addition, conformity with federal law reduces the taxpayer's compliance burden.

Generally, California law provides a deduction for up to 75% of qualifying dividends received from foreign corporations that are included in the water's-edge income base. This deduction is known as the "foreign dividend deduction." Opponents may argue that the foreign dividend deduction should be applied to Subpart F deemed dividends. However, if the 75% foreign dividend deduction were applied to the Subpart F deemed dividends, most of the "tax haven income" would be reduced by the deduction. This would result in a loss of revenue.

Other States

Other states have variations on the rules for apportionment of income of the activities of multinational corporations conducted in foreign countries. However, no other state taxes on a water's-edge basis similar to California. Thus, it does not appear that these issues apply to other states.

LEGISLATIVE STAFF CONTACT

Marion Mann DeJong
Franchise Tax Board
845-6979
Marion.DeJong@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
Brian.Putler@ftb.ca.gov

Analyst Marion Mann DeJong
Telephone # 845-6979
Attorney Patrick Kusiak

FRANCHISE TAX BOARD’S
PROPOSED AMENDMENTS TO LP 03-23

AMENDMENT 1

Section 1. Section 25110 of the Revenue and Taxation Code is amended to read:

25110. (a) Notwithstanding Section 25101, a qualified taxpayer, as defined in paragraph (2) of subdivision (b), that is subject to the tax imposed under this part, may elect to determine its income derived from or attributable to sources within this state pursuant to a water's-edge election in accordance with the provisions of this part, as modified by this article. A taxpayer that makes a water's-edge election shall take into account the income and apportionment factors of the following affiliated entities only:

(1) Domestic international sales corporations, as described in Sections 991 to 994, inclusive, of the Internal Revenue Code and foreign sales corporations as described in Sections 921 to 927, inclusive, of the Internal Revenue Code.

(2) Any corporation (other than a bank), regardless of the place where it is incorporated if the average of its property, payroll, and sales factors within the United States is 20 percent or more.

(3) Corporations that are incorporated in the United States, excluding corporations making an election pursuant to Sections 931 to 936, inclusive, of the Internal Revenue Code, of which more than 50 percent of their voting stock is owned or controlled directly or indirectly by the same interests.

(4) A corporation that is not described in paragraphs (1) to (3), inclusive, or paragraph (5), but only to the extent of its income derived from or attributable to sources within the United States and its factors assignable to a location within the United States in accordance with paragraph (3) of subdivision (b). Income of that corporation derived from or attributable to sources within the United States as determined by federal income tax laws shall be limited to and determined from the books of account maintained by the corporation with respect to its activities conducted within the United States.

(5) Export trade corporations, as described in Sections 970 to 972, inclusive, of the Internal Revenue Code.

(6) Any affiliated corporation which is a "controlled foreign corporation," as defined in Section 957 of the Internal Revenue Code, if all or part of the income of that affiliate is defined in Section 952 of Subpart F of the Internal Revenue Code ("Subpart F income"). The income and apportionment factors of any affiliate to be included under this paragraph shall be determined by multiplying the income and apportionment factors of that affiliate without application of this paragraph by a fraction (not to exceed one), the numerator of which is the "Subpart F income" of that corporation for that taxable year and the denominator of which is the "earnings and profits" of that corporation for that taxable year, as defined in Section 964 of the Internal Revenue Code. <u>This</u>

paragraph shall not be applicable for taxable years beginning on or after January 1, 2003, except to the extent provided by subdivision (g) of Section 25113.

(7)(A) The income and factors of the above-enumerated corporations shall be taken into account only if the income and factors would have been taken into account under Section 25101 if this section had not been enacted.

(B) The income and factors of a corporation that is not described in paragraphs (1) to (3), inclusive, and paragraph (5) and that is an electing taxpayer under this subdivision shall be taken into account in determining its income only to the extent set forth in paragraph (4).

(b) For purposes of this article and Section 24411:

(1) An "affiliated corporation" means a corporation that is a member of a commonly controlled group as defined in Section 25105.

(2) A "qualified taxpayer" means a corporation which does both of the following:

(A) Files with the state tax return on which the water's-edge election is made a consent to the taking of depositions at the time and place most reasonably convenient to all parties from key domestic corporate individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board as provided in Section 19504 or by the State Board of Equalization as provided in Title 18, California Code of Regulations, Section 5005, or by the courts of this state as provided in Chapter 2 (commencing with Section 1985) of Title 3 of Part 4 of, and Section 2025 of, the Code of Civil Procedure. The consent relates to issues of jurisdiction and service and does not waive any defenses a taxpayer may otherwise have. The consent shall remain in effect so long as the water's-edge election is in effect and shall be limited to providing that information necessary to review or to adjust income or deductions in a manner authorized under Sections 482, 861, Subpart F of Part III of Subchapter N, or similar provisions of the Internal Revenue Code, together with the regulations adopted pursuant to those provisions, and for the conduct of an investigation with respect to any unitary business in which the taxpayer may be involved.

(B) Agrees that for purposes of this article, dividends received by any corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) from either of the following are functionally related dividends and shall be presumed to be business income:

(i) A corporation of which more than 50 percent of the voting stock is owned, directly or indirectly, by members of the unitary group and which is engaged in the same general line of business.

(ii) Any corporation that is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or that sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. "Significant," as used in this subparagraph, means an amount of 15 percent or more of either input or output.

All other dividends shall be classified as business or nonbusiness income without regard to this subparagraph.

(3) The definitions and locations of property, payroll, and sales shall be determined under the laws and regulations that set forth the apportionment formulas used by the individual states to assign net income subject to taxes on or measured by net income in that state. If a state does not impose a tax on or measured by net income or does not have laws or regulations with respect to the assignment of property, payroll, and sales, the laws and regulations provided in Article 2 (commencing with Section 25120) shall apply.

Sales shall be considered to be made to a state only if the corporation making the sale may otherwise be subject to a tax on or measured by net income under the Constitution or laws of the United States, and shall not include sales made to a corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) in determining the amount of income of the taxpayer derived from or attributable to sources within this state.

(4) "The United States" means the 50 states of the United States and the District of Columbia.

(c) All references in this part to income determined pursuant to Section 25101 shall also mean income determined pursuant to this section.

SEC.2. Section 25113 is added to the Revenue and Taxation Code to read:

25113. (a) The income that is taken into account under Section 25110 for purposes of determining a taxpayer's income derived from or attributable to sources within this state shall include the "Subpart F items" of the members of the water's-edge group.

(b) For purposes of this section:

(1)(A) "Subpart F items" means the amounts properly included in the gross income of each of the members of the water's-edge group for federal purposes under Section 951 of the Internal Revenue Code.

(B) "Subpart F items" do not include amounts properly excluded from the gross income of the members of the water's-edge group for federal purposes pursuant to Section 959 (other than Section 959(a)(1)) of the Internal Revenue Code.

(2) "Water's-edge group" means all corporations or other entities whose income and apportionment factors are taken into account pursuant to Section 25110 in computing the income of the individual taxpayer for the current taxable year, which are derived from or attributable to sources within this state.

(c)(1) For purposes of determining whether the Subpart F item taken into account under subdivision (a) is business income or nonbusiness income pursuant to Section 25120, the Subpart F item shall be treated as if it were a dividend paid by the controlled foreign corporation.

(2) The Subpart F item shall not be subject to the provisions of Section 24411.

(d)(1) To the extent amounts distributed to a shareholder are attributable to Subpart F earnings and profits of a foreign corporation, the distribution shall be excluded from the gross income of that shareholder regardless of whether the distribution occurs in a year in which the shareholder is filing on a water's-edge basis.

(2) For purposes of this subdivision, "Subpart F earnings and profits" means the earnings and profits of a foreign corporation attributable to amounts that are, or have been, included in the gross income subject to apportionment and allocation of a member of a water's-edge group pursuant to subdivision (a).

(3)(A) This subdivision shall apply whether the Subpart F earnings and profits are distributed directly or indirectly through a chain of ownership.

(B) For purposes of this paragraph, "indirectly through a chain of ownership" has the same meaning as described under Section 958(a) of the Internal Revenue Code.

(4) Section 964(a) and Section 964(b) of the Internal Revenue Code shall apply for purposes of determining the earnings and profits of a foreign corporation.

(5)(A) Except as modified by subparagraph (B), Section 959 of the Internal Revenue Code shall apply.

(B) Section 959(c)(1) and Section 959(c)(2) of the Internal Revenue Code shall apply only to earnings and profits attributable to Subpart F items included in the gross income subject to apportionment and allocation of a member of a water's-edge group pursuant to subdivision (a). Section 959(c)(3) of the Internal Revenue Code shall apply to all other earnings and profits.

(e) The following rules shall apply with respect to the basis of stock in a controlled foreign corporation held by a member of the water's-edge group, and the basis of property owned by a member of the water's-edge group that is considered to be stock of a controlled foreign corporation pursuant to Section 958(a)(2) of the Internal Revenue Code.

(1) The basis of stock or other property considered to be stock of a controlled foreign corporation shall be increased by the amount of Subpart F items required to be included in that member's gross income pursuant to subdivision (a). The increase in basis shall be limited to the amount actually included in the gross income of the member.

(2)(A) The basis of stock or other property considered to be stock of a controlled foreign corporation shall be reduced by the amount of distributions excluded from gross income pursuant to subdivision (d).

(B) To the extent that an amount excluded from gross income pursuant to subdivision (d) exceeds the adjusted basis of the stock or other property considered to be stock of a controlled foreign corporation, the amount shall be treated as gain from the sale or exchange of property.

(3) To the extent consistent with this subdivision, federal regulations under Section 961 of the Internal Revenue Code shall apply.

(f) To the extent the same item of income would be taken into account pursuant to paragraph (4) of subdivision (a) of Section 25110 and is treated as Subpart F income for federal purposes pursuant to Section 952(b) of the Internal Revenue Code, that item of income shall be treated as a Subpart F item pursuant to this section and not taken into account pursuant to paragraph (4) of subdivision (a) of Section 25110.

(g)(1) This section shall apply:

(A) For taxable years beginning on or after January 1, 2010.

(B) For water's edge elections that begin with taxable years beginning on or after January 1, 2003.

(C) For a water's edge election in effect on January 1, 2003, if an election is made in accordance with paragraph (3) of this subdivision to have this section apply to taxable years beginning on or after January 1, 2003 and before January 1, 2010.

(2) Paragraph (6) of subdivision (a) of Section 25110 shall apply in all circumstances not described in subparagraphs (A) through (C) of paragraph (1).

(3)(A) The election to have this section apply shall be made by filing a return and computing income in a manner consistent with the provisions of this section. Except as otherwise provided, if any member of the water's edge group makes that election, the election shall be binding upon all other members of the group including members that later become members of a water's edge group that includes on or more electing taxpayers. Thereafter, the election shall apply to all then existing controlled foreign corporations and any that may later be acquired by a member of the water's edge group. In the case of a water's-edge group with taxpayer members having different fiscal year ends, the election to have this section apply shall be operative as of the first day of a taxable year of the first member of the water's-edge group that elects to have this section apply. For those entities filing a group return, as defined by 18 California Code of Regulations section 25106.5, subsection (b)(13), the key corporation, as defined by 18 California Code of Regulations section 25106.5, subsection (b)(14), or the common parent of the group, as defined by subdivision (b) of Section 25105, can make the election on behalf of the group.

(B) The election made pursuant to this paragraph to have this section apply is irrevocable and shall apply for the balance of the water's-edge election period. However, in the event that the water's edge group consists of both electing and nonelecting taxpayer members (including circumstances where a nonelecting taxpayer later becomes a member of a water's edge group that includes an electing taxpayer), and the facts and circumstances indicate that the nonelecting taxpayer or taxpayers are the predominant taxpayer members of the group, the taxpayer members of the water's edge group may request permission of the Franchise Tax Board to terminate or nullify the election.

(h) The Franchise Tax Board shall prescribe regulations as may be necessary and appropriate to carry out the purposes of this section.

LEGISLATIVE PROPOSAL 03-24
EXECUTIVE SUMMARY

- **Title:** Water's-Edge Election Procedures

- **Background:** California law allows corporations to elect to determine their income on a "water's-edge" basis or a worldwide unitary basis. The election to report income on a water's-edge basis is made by contract between the taxpayer and FTB. Many electors inadvertently fail to comply with the contractual requirements for making a water's-edge election, thus their water's-edge election is forfeited and their income is determined on a worldwide unitary basis.

- **Problem Statement:** A substantial number of taxpayers still have potentially invalid elections that cannot be perfected under the regulations or present statutes. These problems arise from three general reasons:

    1. The present statutory scheme applies contract law principles alongside tax law principles, which sometimes give incompatible results.
    2. Water's-edge group members make inconsistent filings or corporate acquisitions result in unintended elections.
    3. Filing and tracking notices of nonrenewal are burdensome both for the taxpayer and for FTB and can result in unintended consequences.

- **Proposed Solution:** Fundamentally reform the water's-edge election procedures. Water's-edge elections would no longer be made by contract, but by statutory election.

- **Major Concerns/Issues:** This proposal would simplify the election process by eliminating contract issues, overriding inconsistent filings by water's-edge group members, and reducing the potential for unintended elections when acquisitions occur. It would also eliminate the administrative burdens for both taxpayers and FTB associated with filing and tracking notices of nonrenewal and would remove unintended consequences resulting from nonrenewal.

- **Revenue:** This proposal would result in revenue losses of $2 million for fiscal years 2004-05 and 2005-06. The revenue losses would make it difficult to find an author. Consideration should be given to find a revenue enhancer to package with this proposal.

2003 Departmental Legislative Proposal
LP 03-24

Title

Water's-Edge Election Procedures

Introduction

This proposal would fundamentally reform the water's-edge election procedures to resolve problems that arise with elections made under the current contract rules. Under this proposal, water's-edge elections would be made by statutory election rather than by contract.

Program History/Background

Generally California law requires corporations that earn income from within and without California to calculate their income using what is called the unitary method. Beginning in 1988 California allowed a corporation to elect to calculate its income on a "water's-edge" basis. Taxpayers make the election by entering into a contract with the Franchise Tax Board (FTB). The water's-edge legislation initially used a contract because it was necessary to justify imposition of the filing requirement of a domestic disclosure spreadsheet (DDS) and payment of the water's-edge election fee. However, the repeal of the DDS filing requirement and the fee in 1994 eliminated this justification for the contract.

Throughout the history of the water's-edge election, statutory and regulatory changes have been made in an attempt to provide relief for water's-edge election problems.

The previous solutions have focused on providing relief for taxpayers that failed to satisfy the stringent procedural requirements of the current election statute rather than reforming the entire manner in which water's-edge elections are made. Despite previous efforts, problems continue to occur for taxpayers and the department. The following is a brief history of the problems and attempts to resolve them.

Since many electors inadvertently failed to comply with the statutory requirements for making a water's-edge election, legislation (SB 1805, Green, Stats. 1994, Ch. 1243) was passed that added Section 18405 to the Revenue and Taxation Code (RTC). RTC Section 18405 provided a period for perfecting elections that were invalid because of unintentional noncompliance. This relief was limited to invalid elections made on the 1988 forms by taxpayers that subsequently requested relief within a specified period. However, election problems continued to occur.

RTC Section 18405 was subsequently amended (SB 887, Hughes, Stats. 1995, Ch. 490) to address the situation where an election was invalid because all but one member of the water's-edge group made the election. Only one water's-edge group perfected its election under this legislation.

In 1996 (SB 1870, Alquist), and again in 1997 (AB 1469, Ducheny and AB 1488, Pringle), additional taxpayer-specific legislation was introduced to allow perfection of certain invalid elections. In response to these bills, department staff recommended in 1997 that legislation be enacted to replace the current law contract requirement with a statutory election. However, such legislation was not

pursued because the Franchise Tax Board Members and the business community preferred a regulatory solution at that time.
In 1998, California Code of Regulations (CCR), title 18, sections 25111 and 25111.1 were amended to provide that a water's-edge election is valid even if a taxpayer failed to comply with procedural or statutory requirements as long as there was substantial performance of the election requirements. A corporation is deemed to have substantially performed if its tax was computed consistent with a water's-edge election and other objective evidence demonstrates that the taxpayer intended to make the election. Generally, objective evidence is shown if the taxpayer attaches any completed water's-edge form to the original return or makes statements on the original return demonstrating the intent to elect.

These amendments cured many election problems but a substantial number of taxpayers have since been identified as having invalid elections that could not be perfected under even these regulations. Consequently, department staff developed LP 00-25 in late 1999. LP 00-25 was basically identical to this proposal. The Franchise Tax Board voted at its December 16, 1999, meeting to sponsor LP 00-25. AB 2741 (Alquist, 1999/2000), and SB 657 (Scott, Stats. 2002, Ch 34) contained LP 00-25. AB 2741 was held in the Assembly Appropriations Committee. The water's-edge provisions were amended out of SB 657 prior to its enactment because of the minor revenue loss.

Current Federal Law

Under current federal law, corporations organized in the U.S. are taxed on all their income, regardless of source, but are allowed a credit for any taxes paid to a foreign country on their foreign source income.

Foreign corporations engaged in a U.S. trade or business are taxed at regular U.S. graduated corporate income tax rates on income effectively connected with the conduct of that business in the U.S. This is known as effectively connected income, or ECI. Additionally, foreign corporations are taxed at a flat 30% rate (or lower rate if provided by treaty) on specified types of fixed, determinable, annual, or periodic income (usually investment income) from U.S. sources.

Current State Law

Under current California law, California source income for corporations that operate both within and without the state is determined on a worldwide basis using the unitary method of taxation. Under the unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of that income is then apportioned to California on the basis of relative levels of business activity in the state measured by property, payroll, and sales.

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine their income on a "water's-edge," or inside of the U.S. basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources. In exchange for filing on a water's-edge basis, the taxpayer agrees to:

- file on a water's-edge basis for seven years;
- treat certain dividends as California income; and
- ensure that methods of substantiating the information on the return will be available (i.e., depositions of key employees or officers, and requiring the reasonable production of documents).

The water's-edge election must be made *by contract* with FTB on the *original return* for the year and is effective only if *every taxpayer* that is a member of the water's-edge group and subject to California franchise or income tax makes the election.

An affiliated corporation that is either a member of the water's-edge group and subsequently becomes subject to tax or a non-electing taxpayer that is subsequently proved to be a member of the water's-edge group pursuant to an FTB audit determination, is deemed to have elected water's-edge treatment. If another corporation pursuant to a corporate reorganization acquires a water's-edge taxpayer, the water's-edge election will carry over and be binding upon the acquiring corporation.

Each water's-edge contract is for an initial term of seven years and is automatically renewed each year thereafter for an additional one-year period unless the taxpayer gives written notice of nonrenewal at least 90 days prior to the anniversary date.

The election will continue indefinitely if a taxpayer elects water's-edge treatment and does not file a notice of nonrenewal. If the taxpayer files a notice of nonrenewal, the election remains in effect for the balance of the period remaining on the original seven-year election or the last renewal of the election.

A taxpayer may terminate a water's-edge election prior to the end of the seven-year period if:

- the taxpayer is acquired, directly or indirectly, by a non-electing entity that alone or together with its affiliates included in a combined report is larger, in terms of equity capital, than the taxpayer, or
- the taxpayer receives permission from FTB to terminate its election.

A taxpayer seeking FTB permission to terminate an election must demonstrate that continuation of the water's-edge requirements would:

- result in a significant disadvantage to the taxpayer, and
- that such disadvantage is the result of an extraordinary or significant event that could not have been reasonably anticipated when the original election was made.

<u>Problem</u>

A substantial number of taxpayers still have potentially invalid elections that cannot be perfected under the regulations or present statutes. These problems arise from three general reasons:

4. The present statutory scheme applies contract law principles alongside tax law principles, which sometimes give incompatible results.
5. Water’s-edge group members make inconsistent filings or corporate acquisitions result in unintended elections.
6. Filing and tracking notices of nonrenewal are burdensome both for the taxpayer and for FTB and can result in unintended consequences.

Proposed Solution

Fundamentally reform the water’s-edge election procedures to replace the contract with a statutory election. In addition, make the following changes relating to water’s-edge elections:

- Codify the “substantial performance” concept currently in the regulations to prevent taxpayers that inadvertently fail to satisfy a procedural aspect of the election from losing their water’s-edge status. This would include inconsistent filings made by water’s-edge group members.

- Reform the acquisition rules so that a water’s-edge taxpayer would no longer automatically “taint” any non-electing affiliates with which it becomes unitary. Instead, when two or more taxpayers become unitary, the status of the larger taxpayer would prevail. This result is more likely to coincide with a taxpayer’s expectations and would prevent a large combined reporting group from becoming unintentionally bound by a water’s-edge election when it acquires a smaller water’s-edge electing taxpayer.

- Eliminate the renewal/nonrenewal provisions. Instead, require a taxpayer that makes a water’s-edge election to request and receive permission from FTB to terminate the election within the first seven taxable years. However, allow the taxpayer to elect to return to a worldwide basis for any taxable year after the taxpayer has filed on a water’s-edge basis for at least seven years. Likewise, after electing to return to a worldwide basis, require the taxpayer to file on a worldwide basis for at least seven taxable years before making another water’s-edge election. However, the taxpayer could request and receive permission from the FTB to make a water’s-edge election prior to the end of that seven-year period.

- Give FTB the authority to perfect elections that are not valid under current law since the other provisions of this proposal would be prospective only.

- Preserve existing law related to water’s-edge elections by clarifying that, unless otherwise specifically provided, for purposes of provisions related to water's-edge elections, the term "Internal Revenue Code" means provisions of Title 26 of the United States Code, as applicable for federal tax purposes for the taxable period. This would effectively separate the normal annual "federal conformity" legislative process from the water's-edge provisions by ensuring that relevant changes to federal tax law applicable to water's-edge filers will be effectively "automatically" picked up in computing the income and deductions of the water's-edge group.

Effective/Operative Date of Solution

If enacted in the 2003 legislative session as a tax levy, this proposal would apply to taxable years beginning on or after January 1, 2003. Water's-edge elections made under prior law would continue with the same commencement date as provided under the prior law.

Justification

Reforming the water’s-edge election procedures would simplify the election process by eliminating contract law issues and the procedural requirements of executing a contract. The water’s-edge legislation initially used a contract because it was necessary to justify imposition of the filing requirement of a domestic disclosure spreadsheet and payment of the water’s-edge election fee. The repeal of the filing requirement and fee eliminated this justification for the contract.

In addition, reforming the water’s-edge election procedures would:

- eliminate inconsistent filings by water’s-edge group members;
- reduce the potential for unintended elections when acquisitions occur;
- eliminate the administrative burdens of filing and tracking notices of nonrenewal, and
- remove unintended consequences of nonrenewal.

Finally, this proposal would allow FTB to work more cooperatively with taxpayers in perfecting their water’s-edge elections.

Implementation

This proposal would improve the department’s ability to administer laws relating to water’s-edge elections. The proposal could be implemented in the department's annual program updates. Water’s-edge elections made for taxable years beginning prior to January 1, 2003, would be made under the prior law. Water’s-edge elections made for taxable years beginning on or after January 1, 2003, would be made according to this proposal.

Fiscal Impact

Departmental Costs

No departmental costs are associated with this proposal.

Tax Revenue Estimate

This proposal would result in the following order of magnitude revenue losses.

Estimated Revenue Impact of LP 03-24 Effective January 1, 2003 [$ In Millions]			
2002-03	2003-04	2004-05	2005-06
none	minor loss	($2)	($2)

Minor loss is less than $500,000.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue impact of this proposal would be determined collectively by: the number of taxpayers with an invalid water's-edge election, the tax differential between water's-edge and worldwide combined reporting for these taxpayers, and the timing of when assessments would have been issued and their eventual collection under current law.

Audit staff has identified 200 to 300 taxpayers with potentially invalid water's-edge elections. The amount of additional taxes from placing these predominantly foreign parent taxpayers on a worldwide combined basis is unknown. For a small sample of these taxpayers, tax returns were examined for purposes of determining an order of magnitude estimate. The cursory examination indicated that foregone assessments could be on the order of $5 million in additional tax for all open tax years. The timing of when assessments would otherwise have been issued and the eventual collection of additional taxes assessed plus interest is speculative. For the estimate, it is assumed that the vast majority of assessments would otherwise have been issued during 2003 and 2004. It is further assumed that eventual collection would have been delayed some two to four years after assessment.

Policy Considerations

The requirement that the election be made by contract between the taxpayer and FTB necessitates an analysis under both tax law and contract law (including the legal concepts of offer and acceptance and substantial compliance) to determine the validity of an election. The two bodies of law (tax, which generally requires strict statutory adherence, and contract, with its more generous application of inferences drawn from facts and circumstances) are neither compatible nor complementary. While the water's-edge legislation initially used a contract because it was necessary to justify imposition of the filing requirement of a domestic disclosure spreadsheet and payment of the water's-edge election fee, these items are no longer required and thus eliminate the justification for the contract. No other apparent policy reason exists for retaining the contract requirement. If the water's-edge election were simply a tax election like any other (e.g., S corporation and installment sales), only tax law would be considered in determining the validity of the election and the mechanics of the election would be simplified.

Other States

Other states have variations on the rules for apportionment of income of the activities of multinational corporations conducted in foreign countries. No other state has a water's-edge election mechanism.

Although *Idaho* and *Alaska* have water's-edge-like elections, they are different than California's water's-edge election.

LEGISLATIVE STAFF CONTACT

Marion Mann DeJong
Franchise Tax Board
845-6979
marion.dejong@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
Brian.Putler@ftb.ca.gov

Analyst Marion Mann DeJong
Telephone # 845-6979
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-24

AMENDMENT 1

SECTION 1. Section 18405.1 is **added** to the Revenue and Taxation Code to read:

18405.1. (a) Notwithstanding Section 18405, the Franchise Tax Board may, in its discretion, permit elections made under Section 25111 to be perfected during the period of limitations prescribed under Section 19057 and 19306 for the applicable taxable year. The statute of limitations of all taxpayers in a water's-edge group whose taxable year falls, in whole or in part, within the period of the election shall remain open to receive adjustments, under claim or deficiency, consistent with that perfection of the election.

(b) Subdivision (a) shall not apply to the 1988 taxable year of any taxpayer whose water's-edge election has been perfected pursuant to Section 18405.

SEC. 2. Section 25111 of the Revenue and Taxation Code is **amended** to read:

25111. (a) For taxable years beginning before January 1, 2003, the ~~The~~ making of a water's-edge election as provided for in Section 25110 shall be made by contract with the Franchise Tax Board in the original return for a year and shall be effective only if every taxpayer that is a member of the water's-edge group and which is subject to tax under this part makes the election. A single taxpayer that is engaged in more than one business activity subject to allocation and apportionment as provided in Article 2 (commencing with Section 25120) of Chapter 17 may make a separate election for each business. The form and manner of making the water's-edge election shall be prescribed by the Franchise Tax Board. Each contract making a water's-edge election shall be for an initial term of 84 months, except as provided in subdivision (b). Each contract shall provide that on the anniversary date of the contract or any other annual date specified by the contract a year shall be added automatically to the initial term unless notice of nonrenewal is given as provided in subdivision (d). An affiliated corporation that is a member of the water's-edge group and subsequently becomes subject to tax under this part or is a non-electing taxpayer that is subsequently proved to be a member of the water's-edge group pursuant to a Franchise Tax Board audit determination, as evidenced by a notice of deficiency proposed to be assessed or a notice of tax change, shall be deemed to have elected.

No water's-edge election shall be made for a taxable year beginning prior to January 1, 1988.

(b) A water's-edge election may be terminated by a taxpayer prior to the end of the 84-month period if either of the following occurs:

(1) The taxpayer is acquired directly or indirectly by a non-electing entity which alone or together with those affiliates included in its combined report is larger than the taxpayer as measured by equity capital.

(2) With the permission of the Franchise Tax Board.

(c) In granting a change of election, the Franchise Tax Board shall impose any conditions that are necessary to prevent the avoidance of tax or to clearly reflect income for the period the election was, or was purported to be, in effect. These conditions may include a requirement that income, including dividends paid from income earned while a water's-edge election was in effect, which would have been included in determining the income of the taxpayer from sources within and without this state pursuant to Section 25101 but for the water's-edge election shall be included in income in the year in which the election is changed.

(d) If the taxpayer desires in any year not to renew the election, the taxpayer shall serve written notice of nonrenewal upon the board at least 90 days in advance of the annual renewal date. Unless that written notice is provided to the board, the election shall be considered renewed as provided in subdivision (a).

(e) If the taxpayer serves notice of intent in any year not to renew the existing water's-edge election, that existing election shall remain in effect for the balance of the period remaining since the original election or the last renewal of the election, as the case may be.

<u>(f) To the extent that a taxpayer would have been required to file on a water’s-edge basis in its first taxable year beginning on or after January 1, 2003, pursuant to a water’s-edge election made in a prior year under this section, the terms of this section shall no longer be applicable and such election shall be deemed to have been made under the terms of Section 25113; however, the commencement date of the election made in a prior year under this section shall continue to be treated as the commencement date of the water’s-edge election period for purposes of applying the provisions of Section 25113.</u>

SEC. 3. Section 25113 is **added** to the Revenue and Taxation Code to read:

25113. (a) Except as provided in subdivision (f), for taxable years beginning on or after January 1, 2003, the election provided for in Section 25110 shall be made on an original, timely filed return for the year of the election. The election will be considered valid if both of the following conditions are satisfied:

(1) The tax is computed in a manner consistent with a water’s-edge election, and

(2) A written notification of election is filed with the return on a form prescribed by the Franchise Tax Board. Pursuant to regulations promulgated under this section, the Franchise Tax Board may accept the filing of other objective evidence that supports the conclusion that a water’s-edge election was intended in lieu of notification on the designated form.

(b) Except as otherwise provided, a water's-edge election shall be effective only if made by every member of the self-assessed combined reporting group that is subject to taxation under this part.

(1) An election made on a group return of a self-assessed combined reporting group shall constitute an election by each taxpayer member included in that group return, unless one of those taxpayers files a separate return in which no election is made and paragraph (2) does not apply. (2) A taxpayer that fails to make an election on its own timely filed original return shall be deemed to have elected if either of the following apply:

(A) It has a parent corporation that is an electing taxpayer which included the income and apportionment factors of the non-electing taxpayer in the self-assessed combined reporting group reflected in the electing parent's timely filed original return (including a group return), or

(B) The income and apportionment factors of the non-electing taxpayer is reflected in the self-assessed combined reporting group of a timely filed original return of an electing taxpayer, and the notification of election filed by the electing taxpayer pursuant to paragraph (2) of subdivision (a) is signed by an officer or other authorized agent of either a parent corporation of the non-electing taxpayer or another corporation with authority to bind the non-electing taxpayer to an election.

(3) For purposes of this subdivision, a "parent corporation" of the taxpayer is a corporation which owns or constructively owns stock possessing more than 50 percent of the voting power of the taxpayer as determined under subdivisions (e) and (f) of Section 25105.

(4) If a corporation that is a member of a combined reporting group is not itself subject to taxation under this part in the year for which the water's-edge election is made, but subsequently becomes subject to taxation under this part, such corporation shall be deemed to have elected with the other taxpayer members of the combined reporting group.

(5) A taxpayer that is engaged in more than one apportioning trade or business as defined in paragraph (6) of subdivision (d) of Section 25128 may make a separate election for each apportioning trade or business.

(c) A water's-edge election shall remain in effect or be terminated in accordance with this subdivision.

(1) Except as otherwise provided in this subdivision, if one or more electing taxpayer members of a combined reporting group later become disaffiliated or otherwise cease to be included in the combined reporting group, the water's-edge election shall remain in effect as to both the departing taxpayer members and any remaining taxpayer members.

(2) If an electing taxpayer and a non-electing taxpayer become members of a new unitary affiliate group, the non-electing taxpayer shall be deemed to have elected if the value of the total business assets of the electing taxpayer (and its component unitary group, if any) is larger than the value of the total business assets of the non-electing taxpayer (and its component unitary group, if any). Otherwise, the water's-edge election shall be automatically terminated at the time the electing members become part of the combined report. For purposes of applying paragraphs (9) and (10), the commencement date of the deemed election shall be the same as the commencement date of the electing taxpayers.

(3) If taxpayers filing under water's-edge elections with different commencement dates become members of a new unitary affiliate group, the earliest election date shall be deemed to apply to all electing taxpayers if the total business assets of the earlier electing taxpayer (and its component unitary group, if any) is larger than the value of the total business assets of the later electing taxpayer (and its component unitary group, if any).

Otherwise, the later election commencement date shall apply to all electing taxpayers.

(4)(A) If a taxpayer with an election that has been terminated under paragraphs (9) or (10) becomes a member of a new unitary affiliate group that includes another electing or non-electing taxpayer not affected by those paragraphs, any water's-edge election of the other taxpayer member (if applicable) shall terminate, and any restrictions on making a new water's-edge election, relating to an election terminated under those paragraphs, shall apply to all taxpayer members of the new unitary affiliate group if the total business assets of the taxpayer with the terminated election (and its component unitary group, if any) is larger than the other taxpayer (and its component unitary group, if any). Otherwise, paragraph (2) of this subdivision shall apply, if applicable. If paragraph (2) of this subdivision does not apply, all taxpayer_members of the new unitary affiliate group will be treated as non-electing taxpayers that are not subject to any restrictions on making a new water's-edge election.

(B) If two non-electing taxpayers with different termination dates under paragraphs (9) or (10) become members of a new unitary affiliate group, the earliest termination date shall be deemed to apply to all non-electing taxpayers, as well as any restrictions on making a new water's-edge election relating to that termination, if the total business assets of the earlier terminating taxpayer (and its component unitary group, if any) is larger than the value of the total business assets of the later terminating taxpayer (and its component unitary group, if any). Otherwise, the later termination date (and the related restrictions on making a new water's-edge election) shall apply to all taxpayer members of the new unitary affiliate group.

(5)(A) Except as provided in subparagraph (B), if one or more electing taxpayers did not report their income and apportionment factors as members of a combined reporting group with one or more non-electing taxpayers, and, pursuant to a Franchise Tax Board audit determination, the non-electing taxpayers are properly in the same combined reporting group as the electing taxpayers, the water's-edge election of the electing taxpayers shall remain in effect and the non-electing taxpayers shall be deemed to have made a water's-edge election. The commencement date of the deemed water's edge election shall be the same as the commencement date of the electing taxpayers.

(B) Subparagraph (A) shall not apply if the value of total business assets of the electing taxpayers does not exceed the value of total business assets of the non-electing taxpayers. In that event, the water's-edge election of each electing taxpayer is terminated as of the date the non-electing taxpayers are, pursuant to the audit determination described in subparagraph (A), properly included in the same combined reporting group as the electing taxpayers.

(C) For purposes of applying the business asset test of this paragraph, the term "business assets" shall have the same meaning as subparagraph A of paragraph (6) of this subdivision, except that the business assets of other members of the unitary affiliate group that are not taxpayers shall not be taken into account.

(D) Notwithstanding subparagraph (A), non-electing taxpayers shall not be deemed to have made a water's-edge election if the Franchise Tax Board audit determination described in subparagraph (A) is withdrawn or otherwise overturned.

(6) For purposes of paragraphs (2) through (5):

(A) "Business assets" are assets (including intangible assets, other than stock of a member of the unitary affiliate group) which are used in the conduct of the business of the unitary affiliate group or would produce business income to the unitary affiliate group (if an election were not in place) if the assets were sold. Business assets shall be valued at net book value.

(B) The phrase "unitary affiliate group" refers to all of those corporations that would constitute a unitary group if a water's-edge election were not made.

(C) The phrase "new unitary affiliate group" refers to a unitary affiliate group that is created by a new affiliation of two or more corporations, or by the addition of one or more new members to an existing unitary affiliate group.

(D) The phrase "component unitary group" means that portion of a group of corporations that have become members of a new unitary affiliate group that were members of their own respective unitary affiliate group prior to entering the new unitary affiliate group (disregarding any corporations that did not become part of the new unitary group).

(7) In the application of paragraphs (2) through (4), a series of acquisitions as steps of a single transaction shall be aggregated as a single change of membership.

(8) In the event of a merger or consolidation, the water's-edge status and election commencement date or termination date of the surviving corporation shall be consistent with the result that would have been obtained under paragraphs (2) through (4) if the surviving corporation had acquired the stock of the transferor corporation.

(9) A water's-edge election may be terminated without the consent of the Franchise Tax Board after it has been in effect for at least 84 months. The termination must be made on an original, timely filed return for the first year in which the water's-edge election is to be terminated. To be effective, the termination must be made by every taxpayer that is a member of the water's-edge group in the same manner as the election provided under subdivisions (a) and (b).

(10) A water's-edge election may be terminated before the 84-month period described in paragraph (a) has elapsed, but only with the consent of the Franchise Tax Board. A request for termination must be made in the time and manner specified by the Franchise Tax Board. Such requests may be granted for good cause. For purposes of this section, good cause shall have the same meaning as specified in Treasury Regulations Section 1.1502-75(c).

(11) Except for deemed elections as provided in paragraphs (2), (4) and (5), if a water's-edge election is terminated under paragraph (9) or (10), another election may not be made under this section for any taxable year that begins within the 84-month period following the last day of the election period that was terminated. The Franchise Tax Board may waive the application of this prohibition period for good cause.

(12) A water's-edge election shall remain in effect until terminated.

(d) For purposes of this section:

(1) A "combined reporting group" means those corporations whose income and apportionment factors are properly considered pursuant to this chapter in computing the income of the individual taxpayer that is derived from or

attributable to sources within this state, taking into account a valid water's-edge election.

(2) A "group return" refers to the single return which taxpayer members of a combined reporting group may elect by contract to file, in the form and manner prescribed by the Franchise Tax Board, in lieu of filing their own respective returns.

(3) A "self-assessed combined reporting group" means that group of corporations whose income and apportionment factors are reflected in a combined report prepared pursuant to this chapter in a timely filed return, taking into account the effects of a purported water's-edge election, whether or not the membership of the corporations in that combined report was correctly determined.

(e) The Franchise Tax Board may prescribe any regulations as may be necessary or appropriate to carry out the purposes of this section.

(f) To the extent that a taxpayer would have been required to file on a water's-edge basis in its first taxable year beginning on or after January 1, 2003, pursuant to a water's-edge election made in a prior year under Section 25111, the terms of Section 25111 shall not be applicable and such election shall be deemed to have been made under the terms of this section; however, the commencement date of the election made in a prior year under Section 25111 shall continue to be treated as the commencement date of the water's-edge election period for purposes of applying the provisions of this section.

SEC. 4. Section 25116 is **added** to the Revenue and Taxation Code to read:

25116. Notwithstanding paragraph (1) of subdivision (a) of Section 23051.5, when provisions of this article refer to provisions of the Internal Revenue Code that are not otherwise applicable for purposes of Part 10.2 (commencing with Section 18401) or this part, the term "Internal Revenue Code" means Title 26 of the United States Code, including all amendments thereto, as in effect for federal purposes for the taxable period, except as otherwise specifically provided in this article.

LEGISLATIVE PROPOSAL 03-25
EXECUTIVE SUMMARY

- **Title:** Apportionment of IRC Section 108--Exclusion of Cancellation of Debt Income, and Section 382--Limitation of NOL Carryforwards Following a Change in the Ownership of a Corporation

- **Problem Statement:** California law fails to specify if conformity to federal laws on both exclusion of cancellation of debt income and limitation on usage of NOL carryforwards following a change of ownership of a corporation (IRC Sections 108 and 382, respectively) are applied on a pre-apportionment or post-apportionment basis.

- **Proposed Solution**: Grant the department legislative rulemaking authority to write regulations to clarify the issue of the impact of apportionment in the application of IRC Sections 108 and 382 for California purposes. Taxpayers' input into the regulation process will be considered in deciding if IRC Sections 108 and 382 will be applied on a pre-apportionment or post-apportionment basis.

- **Major Concerns/Issues:** The reduction of tax attributes from the COD issue is presently scheduled in November for a hearing before the Board of Equalization. The appellant in that appeal, Wilshire Restaurant Group, has asserted that IRC Section 108 should be properly applied on a post-apportionment basis.

- **Revenue:** The revenue impact associated with this proposal is unknown at this time. Any revenue impact is dependent upon the specific regulations that would be adopted.

2003 Departmental Legislative Proposal
LP 03-25

Title

Apportionment of IRC Section 108--Exclusion of Cancellation of Debt Income, and Section 382--Limitation of NOL Carryforwards Following a Change in the Ownership of a Corporation

Introduction

This proposal would delegate to the Franchise Tax Board (FTB) legislative rulemaking authority to issue regulations to clarify whether exclusion of “cancellation of debt” (COD) income and the limitation of “net operating losses” (NOL) after a corporate ownership change are to be applied on a pre-apportionment or post-apportionment basis for state purposes. Input from taxpayers during the rulemaking process will be used in determining if the COD income exclusion and NOL limitation will be applied on a pre-apportionment or post-apportionment basis.

Current Federal/State Laws

General Net Operating Losses

Federal and state laws allow a “net operating loss” (NOL) in Internal Revenue Code (IRC) Section 172 and conformed to by reference in Corporation Tax Law (CTL) Section 24416. Federal law permits the carryback of an NOL to two preceding tax years and a carryforward of 20 tax years. State law conforms to federal law but does not permit the carryback of an NOL and generally allows the carryforward for up to 10[2] tax years. The other main federal/state difference is the amount of the NOL that is allowed to be carried forward. For general NOLs, California allows the following percentage of the NOL to be carried forward:

Taxable Years Beginning In	Allowable % of NOL Carryforward
1999 and prior	50%
2000 - 2001	55%
2002 - 2003*	60%
2004 and thereafter	100%

*NOTE: AB 2065 (Stats. 2002, Ch. 488) suspended the deduction of all NOLs for the 2002 and 2003 tax years and increased the carryforward amount to 100% beginning in 2004.

California law provides special NOL treatment for new and small businesses, as defined, and certain NOLs incurred in specific economic development areas and industries.

[2] Prior to 2000, the general carryover period was five years.

IRC Section 382 - NOL Carryforward Limitation

IRC Section 382 limits the NOL deduction available in certain corporate acquisitions by slowing down the rate that the acquired corporation can use the loss carryovers. Specifically, the "Section 382 limitation" does not allow the buyer to use the loss carryovers at a faster rate than the loss corporation could have used them if it had sold its assets and invested the proceeds in tax-exempt government obligations. The purpose of this rule is to make loss carryovers a neutral factor in a corporate acquisition. Prior to the limitation, corporations with large losses were being purchased by corporations with high incomes simply because the acquired corporation's losses could be used to offset the buyer's tax liability. In fact, IRC Section 382 now makes NOL carryovers less attractive to the acquiring corporation than the loss corporation.

Federal law provides that the cancellation of debt (COD) is income to the entity in which the debt was discharged. An exception to this general rule is contained in IRC Section 108. IRC Section 108 provides for the reduction of tax attributes (NOLs, credits, basis, etc.) rather than the inclusion of income from COD if the entity was insolvent at the time of the cancellation or the cancellation took place during bankruptcy.

Current State Law

An apportioning corporation must determine its NOL from California sources. This is accomplished by totaling its apportioned and allocated income and losses attributable to California. Any resulting NOL can be used to offset the corporation's future operating income, or carried forward until it expires. A corporation that is a member of a combined report must separately compute its share of the combined group's California-source NOL using intrastate apportionment and income allocation rules. Each member of the combined report can have its own California-source NOL carryover that may only be applied against its California-source income in subsequent years.

California conforms to IRC Section 382. IRC Section 382 may further limit the allowable California NOL by imposing restrictions on NOL carryforwards and certain built-in losses following an ownership change. The Section 382 limitation could suspend deductions otherwise allowable to a new loss corporation for any post-acquired year. The IRC Section 382 limitation for any post-acquired year is an amount equal to the value of the old loss corporation (determined by reference to the fair market value of its stock) multiplied by the long-term tax-exempt rate. If the IRC Section 382 limitation for any post-acquisition year exceeds the taxable income of the new loss corporation for such year that was offset by pre-acquired losses, then the IRC Section 382 limitation for the next post-acquisition year shall be increased by the amount of such excess.

California law conforms to IRC Section 108 by reference in CTL Section 24307.

The outcome of applying IRC Section 108 or Section 382 for California purposes can differ depending on whether the provisions of either of the two IRC sections are applied pre-apportionment or post-apportionment.

For Example, for its 12/31/99 year-end, ABC Corporation's federal NOL carryover is $2 million. ABC's California apportionment factor is 20%. ABC Corporation has a $400,000 California NOL, and a $200,000 NOL carryover ($2 million x 20% x 50%). On January 1, 2000, B Corporation acquires ABC's stock for $10,000,000. The long-term tax-exempt rate on that date is 5%. For federal purposes the IRC Section 382 limitation is $500,000 ($10,000,000 x 5% = $500,000). For federal purposes the ABC Corporation's NOL deduction is limited by IRC Section 382 to $500,000 for 2000 and 2001.

For California purposes the Section 382 limitation on the NOL could be computed as follows:

Pre-apportionment – The full $200,000 NOL is deductible because it is less than the federal amount of $500,000. (The California post-apportionment NOL of $200,000 is less than the pre-apportionment limitation of $500,000.)

Post-apportionment - The $200,000 carry forward is limited to $100,000 for the current taxable year and $100,000 for the next succeeding taxable year (The IRC Section 382 limitation of $500,000 is apportioned ($500,000 X 20%) resulting in a California limitation of $100,000.)

A similar outcome would result from applying the provisions of IRC Section 108 on a pre-apportionment and post-apportionment basis.

CTL Section 23051.5 clarifies the relationship of California and federal tax laws where California conforms to federal law by reference to the IRC. CTL Section 23051.5(h) provides that when applying the IRC for state purposes due account shall be made for differences in federal and state terminology and other obvious differences. It is not clear if applying IRC Sections 108 and 382 post-apportionment is an obvious difference

Problem

California law fails to specify if conformity to federal laws on both exclusion of cancellation of debt income and limitation on usage of NOL carryforwards following a change of ownership of a corporation (IRC Sections 108 and 382, respectively) are applied on a pre-apportionment or post-apportionment basis.

Proposed Solution

Grant the department legislative rulemaking authority to write regulations to clarify the issue of the impact of apportionment in the application of IRC Sections 108 and 382 for California purposes. Taxpayers' input into the regulation process will be considered in deciding if IRC Sections 108 and 382 will be applied on a pre-apportionment or post-apportionment basis.

Effective/Operative Date of Solution

As a tax levy the provision would be effective immediately upon enactment. However, this proposal would give authority to issue regulations that could be effective the taxable year in which a public notice substantially describing the expected contents of the regulation is released. If the regulations are issued within 24 months of the passage of this proposal, the regulations could be effective in the taxable year this proposal is enacted. The three-member Board will determine the effective date of the regulation within the parameters of the law described above.

Justification

IRC Sections 108 and 382 should be applied on an internally consistent basis--either both should be applied pre-apportionment or both should be applied post-apportionment. Legislative regulations are given greater deference by the courts than interpretive regulations and such a delegation of legislative rulemaking authority is often used by the Legislature when the complexity of the rules to be drafted dictate that the actual drafting may be better accomplished by the administrative agency rather than the Legislature itself. This proposal satisfies that standard because taxpayer input is needed during the rulemaking process to ensure the intricate workings of individual affected industries and taxpayer groups are appropriately addressed. The department has in the past issued substantive regulations under CTL Section 25106.5, relating to the mechanics of combined reporting.

Implementation

Implementing this proposal would not significantly impact the department's programs and operations.

Fiscal Impact

Departmental Costs

This proposal will not significantly increase the department's cost.

Revenue Estimate

The revenue impact associated with this proposal is unknown at this time. Any revenue impact is dependent upon the specific regulations that would be adopted.

Other States

It could not be determined from review of the *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota* and *New York* state income tax systems whether IRC Sections 108 and 382 are required to be applied on a pre-apportionment or post-apportionment basis. Therefore, it appears that other states, like California, do not specifically state how to apply the IRC sections.

Potential Compromises

The department could write non-binding interpretive regulations or let the issue be decided by the State Board of Equalization under the appeal process and by the courts. In any of those situations, however, the uncertainty that exists under current law would remain until final resolution by the courts or ultimately the Legislature in future legislation.

Additional Comments

Generally, regulations are written by the department with input from the public and approved by the three-member FTB. Resolving the problem stated in this proposal in this manner demonstrates that the department is a responsive agency. The reduction of tax attributes from the COD issue is presently scheduled in November for a hearing before the Board of Equalization. The appellant in that appeal, Wilshire Restaurant Group, has asserted that IRC Section 108 should be properly applied on a post-apportionment basis. The appellant's primary reason for applying Section 108 post-apportionment is that if appellant had not been insolvent at the time the debt was cancelled or forgiven, the amount of the forgiveness would have been reported as business income and apportioned to the members of the combined report. Therefore, it is appellant's position that because any reportable income from COD is apportioned, the reduction of tax attributes should also be apportioned. Appellant also states the reduction of the tax attributes should be apportioned because apportionment is an obvious difference as described in CTL Section 23051.5. The department's position is that appellant has no authority under IRC Section 108 and CTL Section 24307 to apportion the COD income amount. CTL Section 24307 contains several modifications to IRC Section 108 and applying IRC Section 108 post-apportionment is not one of the modifications.

LEGISLATIVE STAFF CONTACT

Jeff Garnier
Franchise Tax Board
845-5322
Jeff.Garnier@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
Brian.Putler@ftb.ca.gov

Analyst Jeff Garnier
Telephone # 845-5322
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-25

AMENDMENT 1

SEC. Section 25106.7 is added to the Revenue and Taxation Code to read:

25106.7 In the case of any income arising as a result of the application of Section 108 of the Internal Revenue Code, relating to income from the discharge of indebtedness, as applicable for purposes of this part, and any loss limitation imposed under Section 382 of the Internal Revenue Code, relating to limitation on net operating loss carryforwards and certain built-in losses following ownership change, as applicable for purposes of this part, the Franchise Tax Board shall adopt regulations prescribing the proper methodology to be used to allocate and apportion any income or loss limitation described above in the case of any taxpayer whose income is determined pursuant to this chapter.

LEGISLATIVE PROPOSAL 03-27
EXECUTIVE SUMMARY

- **Title:** Effect of Federal Elections Made Prior to Becoming a California Taxpayer

- **Problem Statement:** California law does not specifically state how to treat federal elections made prior to the time a person becomes a California taxpayer, which allows new California taxpayers to change their federal electionsfor California purposes thereby providing an unprecedented opportunity for retroactive tax planning.

- **Proposed Solution:** Amend the general election rules for elections to which California conforms to by reference to clarify that federal elections made before becoming a California taxpayer are binding for California purposes. This general rule would apply to all elections unless otherwise provided in another California law or regulation.

- **Major Concerns/Issues:** None.

- **Revenue:** Since this bill would codify existing practice, it would not impact the state's income tax revenue.

2003 Departmental Legislative Proposal
LP 03-27

Title

Effect of Federal Elections Made Prior to Becoming a California Taxpayer

Introduction

This proposal would mandate that federal tax elections made by a person prior to becoming a California taxpayer apply for California purposes.

Program History/Background

Federal and state laws and regulations provide taxpayers with approximately 200 choices (elections) that must be made in determining the amount of their tax. An election is generally the choice to select one method from two or more different methods of reporting a particular item affecting the amount of tax. For example, a business taxpayer that purchases business equipment may choose either to claim a depreciation deduction for the equipment or to elect to expense a portion of the cost of the equipment.

The following is a partial list of areas of the tax law that contain federal tax elections:

- Tax Credits
- Computation of Taxable Income and Applicable Tax
- Corporate Distributions and Adjustments
- Accounting Periods and Methods
- Personal Holding Companies
- Estates, Trusts, Beneficiaries, and Decedents
- Partners and Partnerships
- Regulated Investment Companies, Real Estate Investment Trusts, and Real Estate Mortgage Investment Conduits
- Gain or Loss on Disposition of Property
- Capital Gains and Losses
- Bonds and Debt Instruments
- S Corporations and Their Shareholders
- Consolidated Returns
- Administration and Procedure

The Standard Federal Tax Reports published by Commerce Clearing House (CCH) provides a comprehensive checklist of important federal elections. The checklist includes the manner in which the election is made, the date by which it must be made, and the authority for the election. The checklist can be used to obtain additional information regarding specific income tax elections.

Current Federal Law

Current federal law provides taxpayers with a variety of elections for determining how to treat certain transactions for income tax purposes. Generally, elections must be made on an original, timely filed tax return. Federal case law has developed the “doctrine of election,” which prohibits a taxpayer that makes an election from revoking or amending that election unless permission is granted by the taxing authority. The purpose of the doctrine is to prevent retroactive tax planning and an undue burden on the administration of the tax laws.

Current State Law

Under current state law, the term “taxpayer” includes any individual, estate, or trust subject to the taxes imposed under the Personal Income Tax Law (PITL) or any person subject to the taxes imposed under the Corporation Tax Law (CTL). The term "person" includes an individual, fiduciary, partnership, limited liability company, corporation, or certain organizations exempt from tax. An "individual" is defined as a natural person.

Current state law generally conforms to the various elections provided under federal law. Current state law provides ” taxpayers” with three general rules regarding elections made when California law conforms to federal law by reference. These general rules also apply when federal law requires a taxpayer to file an application or seek consent regarding how to treat a transaction for tax purposes. These three election rules are:

1. A proper election filed with the Internal Revenue Service (IRS) in accordance with federal law or regulation is deemed to be a proper election for California, unless otherwise provided in another California law or regulation (examples of elections include the depreciation method and rate elections).

2. A copy of the federal election must be furnished to the Franchise Tax Board (FTB) upon request.

3. A separate California election can be made to obtain treatment other than the treatment elected for federal purposes unless another California law or regulation specifies how a transaction must be treated. Separate elections must be filed with FTB at the time and in the manner required by FTB. Generally, separate state elections, like most elections for federal purposes, must be made on an original, timely filed state tax return.

The general rules regarding elections apply only to “taxpayers.” FTB’s legal staff has interpreted this to mean that a California taxpayer is not allowed to make a separate state election for tax years or transactions that occurred prior to becoming a California taxpayer. Staff has informed such taxpayers that they are bound by their federal elections for state purposes.

Generally, a nonresident or a part-year resident individual taxpayer will file a Form 540NR, California Nonresident or Part-Year Resident Income Tax Return. Form 540NR requires the individual to report their income on a world-wide basis (total taxable income or total TI) in one column and California-sourced income in another column. An average tax rate is determined based on the “tax on total TI” over “total TI.” This average tax rate is applied against California-sourced income to determine the nonresident’s or part-year resident’s tax liability.

Problem

California law does not specifically state how to treat federal elections made prior to the time a person becomes a California taxpayer, which allows new California taxpayers to change their federal electionsfor California purposes thereby providing an unprecedented opportunity for retroactive tax planning.

Proposed Solution

Amend the general election rules for elections to which California conforms to by reference to clarify that federal elections made before becoming a California taxpayer are binding for California purposes. This general rule would apply to all elections unless otherwise provided in another California law or regulation.

Effective/Operative Date of Solution

If enacted in the 2003 legislative session as an administrative measure, this proposal would be operative January 1, 2004.

Justification

This proposal would codify existing department practice. It would clarify the legal effect for California tax purposes of a federal tax election made prior to a taxpayer becoming a California taxpayer. This proposal would add certainty for taxpayers and department staff regarding how to treat prior transactions. For purposes of this proposal, prior transactions would be transactions that occurred before a taxpayer became a California taxpayer but, due to the election, are being reported over a period that includes periods before and after the taxpayer first became a California taxpayer. This proposal would also reduce potential conflicts between taxpayers and the department regarding how to treat prior elections.

Implementation

Because this proposal codifies current department practice, implementing this proposal would not impact the department's programs and operations.

Fiscal Impact

Departmental Costs

This proposal would not significantly impact the department's costs.

Tax Revenue Estimate

Since this bill would codify existing practice, it would not impact the state's income tax revenue.

Policy Considerations

This proposal would require taxpayers to treat transactions that occurred and elections that were made prior to becoming a California taxpayer consistent with how the transaction or election was treated for federal purposes. This is consistent with California's general tax policy of conforming to federal laws and treating transactions and elections in the same manner as they were treated for federal purposes. Requiring the federal election made by persons prior to becoming a California taxpayer to apply for California purposes also follows the federal doctrine of election.

Other States

The laws of *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York* were reviewed to determine how those states treat federal elections. The laws of these states were reviewed because their tax laws are similar to California's income tax laws. These states generally bind all federal elections where applicable.

LEGISLATIVE STAFF CONTACT

Jeff Garnier	Brian Putler
Franchise Tax Board	Franchise Tax Board
845-5322	845-6333
Jeff.Garnier@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst Jeff Garnier
Telephone # 845-5322
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-27
AMENDMENT 1

SECTION 1. Section 17024.5 of the Revenue and Taxation Code is amended to read:

17024.5. (a) (1) Unless otherwise specifically provided, the terms ''Internal Revenue Code,'' ''Internal Revenue Code of 1954,'' or ''Internal Revenue Code of 1986,'' for purposes of this part, mean Title 26 of the United States Code, including all amendments thereto as enacted on the specified date for the applicable taxable year as follows:

Taxable Year	Specified Date of Internal Revenue Code Sections
(A) For taxable years beginning on or after January 1, 1983, and on or before December 31, 1983	January 15, 1983
(B) For taxable years beginning on or after January 1, 1984, and on or before December 31, 1984	January 1, 1984
(C) For taxable years beginning on or after January 1, 1985, and on or before December 31, 1985	January 1, 1985
(D) For taxable years beginning on or after January 1, 1986, and on or before December 31, 1986	January 1, 1986
(E) For taxable years beginning on or after January 1, 1987, and on or before December 31, 1988	January 1, 1987
(F) For taxable years beginning on or after January 1, 1989, and on or before December 31, 1989	January 1, 1989
G) For taxable years beginning on or after January 1, 1990, and on or before December 31, 1990	January 1, 1990
(H) For taxable years beginning on or after January 1, 1991, and on or before December 31, 1991	January 1, 1991
(I) For taxable years beginning on or after January 1, 1992, and on or before December 31, 1992	January 1, 1992
(J) For taxable years beginning on or after January 1, 1993, and on or before December 31, 1996	January 1, 1993
(K) For taxable years beginning on or after January 1, 1997, and on or before December 31, 1997	January 1, 1997
(L) For taxable years beginning on or after January 1, 1998, and on or before December 31, 2001	January 1, 1998
(M) For taxable years beginning on or after January 1, 2002	January 1, 2001

(2) Unless otherwise specifically provided, for federal laws enacted on or after January 1, 1987, and on or before the specified date for the taxable year, uncodified provisions that relate to provisions of the Internal Revenue Code that are incorporated for purposes of this part

shall be applicable to the same taxable years as the incorporated provisions.

(3) Subtitle G (Tax Technical Corrections) and Part I of Subtitle H (Repeal of Expired or Obsolete Provisions) of the Revenue Reconciliation Act of 1990 (Public Law 101-508) modified numerous provisions of the Internal Revenue Code and provisions of prior federal acts, some of which are incorporated by reference into this part. Unless otherwise provided, the provisions described in the preceding sentence, to the extent that they modify provisions that are incorporated into this part, are declaratory of existing law and shall be applied in the same manner and for the same periods as specified in the Revenue Reconciliation Act of 1990.

(b) Unless otherwise specifically provided, when applying any provision of the Internal Revenue Code for purposes of this part, a reference to any of the following shall not be applicable for purposes of this part:

(1) Except as provided in Chapter 4.5 (commencing with Section 23800) of Part 11 of Division 2, an electing small business corporation, as defined in Section 1361(b) of the Internal Revenue Code.

(2) Domestic international sales corporations (DISC), as defined in Section 992(a) of the Internal Revenue Code.

(3) A personal holding company, as defined in Section 542 of the Internal Revenue Code.

(4) A foreign personal holding company, as defined in Section 552 of the Internal Revenue Code.

(5) A foreign investment company, as defined in Section 1246(b) of the Internal Revenue Code.

(6) A foreign trust, as defined in Section 679 of the Internal Revenue Code.

(7) Foreign income taxes and foreign income tax credits.

(8) Section 911 of the Internal Revenue Code, relating to United States citizens living abroad.

(9) A foreign corporation, except that Section 367 of the Internal Revenue Code shall be applicable.

(10) Federal tax credits and carryovers of federal tax credits.

(11) Nonresident aliens.

(12) Deduction for personal exemptions, as provided in Section 151 of the Internal Revenue Code.

(13) The tax on generation-skipping transfers imposed by Section 2601 of the Internal Revenue Code.

(14) The tax, relating to estates, imposed by Section 2001 or 2101 of the Internal Revenue Code.

(c) (1) The provisions contained in Sections 41 to 44, inclusive, and 172 of the Tax Reform Act of 1984 (Public Law 98-369), relating to treatment of debt instruments, shall not be applicable for taxable years beginning before January 1, 1987.

(2) The provisions contained in Public Law 99-121, relating to the treatment of debt instruments, shall not be applicable for taxable years beginning before January 1, 1987.

(3) For each taxable year beginning on or after January 1, 1987, the provisions referred to by paragraphs (1) and (2) shall be applicable for purposes of this part in the same manner and with respect to the same obligations as the federal provisions, except as otherwise provided in

this part.

(d) When applying the Internal Revenue Code for purposes of this part, regulations promulgated in final form or issued as temporary regulations by ''the secretary'' shall be applicable as regulations under this part to the extent that they do not conflict with this part or with regulations issued by the Franchise Tax Board.

(e) Whenever this part allows a taxpayer to make an election, the following rules shall apply:

(1) A proper election filed with the Internal Revenue Service in accordance with the Internal Revenue Code or regulations issued by ''the secretary'' shall be deemed to be a proper election for purposes of this part, unless otherwise provided in this part or in regulations issued by the Franchise Tax Board.

(2) A copy of that election shall be furnished to the Franchise Tax Board upon request.

(3) (A) Except as provided in subparagraph (B), to ~~To~~ obtain treatment other than that elected for federal purposes, a separate election shall be filed at the time and in the manner required by the Franchise Tax Board.

(B) (i) A proper election of a taxpayer made for federal income tax purposes prior to a taxpayer becoming subject to tax under this part or Part 11 (commencing with Section 23001) shall also be an election for purposes of this part, Part 10.2 (commencing with Section 18401), and Part 11 (commencing with Section 23001), as applicable, and a separate election for those purposes shall not be allowed, unless otherwise expressly provided in this part, Part 10.2 (commencing with Section 18401), or Part 11 (commencing with Section 23001), or in regulations issued by the Franchise Tax Board.

(ii) If a proper election has not been made for federal income tax purposes prior to a taxpayer becoming subject to tax under this part or Part 11 (commencing with Section 23001), a separate election for purposes of this part, Part 10.2 (commencing with Section 18401), or Part 11 (commencing with Section 23001) shall not be allowed, unless otherwise expressly provided in this part, Part 10.2 (commencing with Section 18401), or Part 11 (commencing with Section 23001), or in regulations issued by the Franchise Tax Board.

(iii) The provisions of this subparagraph shall be applicable only to the extent that the provisions of the Internal Revenue Code or regulations authorizing an election for federal income tax purposes are applicable for purposes of this part, Part 10.2 (commencing with Section 18401), or Part 11 (commencing with Section 23001).

(f) Whenever this part allows or requires a taxpayer to file an application or seek consent, the rules set forth in subdivision (e) shall be applicable with respect to that application or consent.

(g) When applying the Internal Revenue Code for purposes of determining the statute of limitations under this part, any reference to a period of three years shall be modified to read four years for purposes of this part.

(h) When applying, for purposes of this part, any section of the Internal Revenue Code or any applicable regulation thereunder, all of the following shall apply:

(1) References to ''adjusted gross income'' shall mean the amount computed in accordance with Section 17072, except as provided in paragraph (2).

(2) References to ''adjusted gross income'' for purposes of computing limitations based upon adjusted gross income, shall mean the

amount required to be shown as adjusted gross income on the federal tax return for the same taxable year.

(3) Any reference to ''subtitle'' or ''chapter'' shall mean this part.

(4) The provisions of Section 7806 of the Internal Revenue Code, relating to construction of title, shall apply.

(5) Any provision of the Internal Revenue Code that becomes operative on or after the specified date for that taxable year shall become operative on the same date for purposes of this part.

(6) Any provision of the Internal Revenue Code that becomes inoperative on or after the specified date for that taxable year shall become inoperative on the same date for purposes of this part.

(7) Due account shall be made for differences in federal and state terminology, effective dates, substitution of ''Franchise Tax Board'' for ''secretary'' when appropriate, and other obvious differences.

(i) Any reference to a specific provision of the Internal Revenue Code shall include modifications of that provision, if any, in this part.

SEC. 2. Section 23051.5 of the Revenue and Taxation Code is amended to read:

23051.5. (a)(1) Unless otherwise specifically provided, the terms "Internal Revenue Code," "Internal Revenue Code of 1954," or "Internal Revenue Code of 1986," for purposes of this part, mean Title 26 of the United States Code, including all amendments thereto, as enacted on the specified date for the applicable taxable year as defined in paragraph (1) of subdivision (a) of Section 17024.5.

(2) Unless otherwise specifically provided, for federal laws enacted on or after January 1, 1987, and on or before the specified date for the taxable year, uncodified provisions that relate to provisions of the Internal Revenue Code that are incorporated for purposes of this part, shall be applicable to the same taxable years as the incorporated provisions.

(3) Subtitle G (Tax Technical Corrections) and Part I of Subtitle H (Repeal of Expired or Obsolete Provisions) of the Revenue Reconciliation Act of 1990 (Public Law 101-508) modified numerous provisions of the Internal Revenue Code and provisions of prior federal acts, some of which are incorporated by reference into this part. Unless otherwise provided, the provisions described in the preceding sentence, to the extent that they modify provisions that are incorporated into this part, are declaratory of existing law and shall be applied in the same manner and for the same periods as specified in the Revenue Reconciliation Act of 1990.

(b) Unless otherwise specifically provided, when applying the Internal Revenue Code for purposes of this part, a reference to any of the following shall not be applicable for purposes of this part:

(1) Domestic International Sales Corporations (DISC), as defined in Section 992(a) of the Internal Revenue Code.

(2) Foreign Sales Corporations (FSC), as defined in Section 922(a) of the Internal Revenue Code.

(3) A personal holding company, as defined in Section 542 of the Internal Revenue Code.

(4) A foreign personal holding company, as defined in Section 552 of the Internal Revenue Code.

(5) A foreign investment company, as defined in Section 1246(b) of the Internal Revenue Code.

(6) A foreign trust as defined in Section 679 of the Internal Revenue Code.

(7) Foreign income taxes and foreign income tax credits.

(8) Federal tax credits and carryovers of federal tax credits.

(c)(1) The provisions contained in Sections 41 to 44, inclusive, and Section 172 of the Tax Reform Act of 1984 (Public Law 98-369), relating to treatment of debt instruments, shall not be applicable for taxable years beginning before January 1, 1987.

(2) The provisions contained in Public Law 99-121, relating to the treatment of debt instruments, shall not be applicable for taxable years beginning before January 1, 1987.

(3) For taxable years beginning on and after January 1, 1987, the provisions referred to by paragraphs (1) and (2) shall be applicable for purposes of this part in the same manner and with respect to the same obligations as the federal provisions, except as otherwise provided in this part.

(d) When applying the Internal Revenue Code for purposes of this part, regulations promulgated in final form or issued as temporary regulations by "the secretary" shall be applicable as regulations issued under this part to the extent that they do not conflict with this part or with regulations issued by the Franchise Tax Board.

(e) Whenever this part allows a taxpayer to make an election, the following rules shall apply:

(1) A proper election filed with the Internal Revenue Service in accordance with the Internal Revenue Code or regulations issued by "the secretary" shall be deemed to be a proper election for purposes of this part, unless otherwise expressly provided in this part or in regulations issued by the Franchise Tax Board.

(2) A copy of that election shall be furnished to the Franchise Tax Board upon request.

(3) (A) Except as provided in subparagraph (B), to ~~To~~ obtain treatment other than that elected for federal purposes, a separate election shall be filed at the time and in the manner required by the Franchise Tax Board.

(B)(i) A proper election of a taxpayer made for federal income tax purposes prior to a taxpayer becoming subject to tax under this part or Part 10 (commencing with Section 17001) shall also be an election for purposes of this part, Part 10 (commencing with Section 17001), and Part 10.2 (commencing with Section 18401), as applicable, and a separate election for those purposes shall not be allowed, unless otherwise expressly provided in this part, Part 10 (commencing with Section 17001), or Part 10.2 (commencing with Section 18401), or in regulations issued by the Franchise Tax Board.

(ii) If a proper election has not been made for federal income tax purposes prior to a taxpayer becoming subject to tax under this part or Part 10 (commencing with Section 17001), a separate election for purposes of this part, Part 10 (commencing with Section 17001), or Part 10.2 (commencing with Section 18401) shall not be allowed, unless otherwise expressly provided in this part, Part 10 (commencing with Section 17001), or Part 10.2 (commencing with Section 18401), or in regulations issued by the Franchise Tax Board.

(iii) The provisions of this subparagraph shall be applicable only to the extent that the provisions of the Internal Revenue Code or regulations authorizing an election for federal income tax purposes are applicable for purposes of this part, Part 10 (commencing with Section 17001), or Part 10.2 (commencing with Section 18401).

(f) Whenever this part allows or requires a taxpayer to file an application or seek consent, the rules set forth in subdivision (e) shall apply to that application or consent.

(g) When applying the Internal Revenue Code for purposes of determining the statute of limitations under this part, any reference to a period of three years shall be modified to read four years for purposes of this part.

(h) When applying, for purposes of this part, any section of the Internal Revenue Code or any applicable regulation thereunder, all of the following shall apply:

(1) For purposes of Chapter 2 (commencing with Section 23101), Chapter 2.5 (commencing with Section 23400), and Chapter 3 (commencing with Section 23501), the term "taxable income" shall mean "net income."

(2) For purposes of Article 2 (commencing with Section 23731) of Chapter 4, the term "taxable income" shall mean "unrelated business taxable income," as defined by Section 23732.

(3) Any reference to "subtitle," "Chapter 1," or "chapter" shall mean this part.

(4) The provisions of Section 7806 of the Internal Revenue Code, relating to construction of title, shall apply.

(5) Any provision of the Internal Revenue Code that becomes operative on or after the specified date for that taxable year shall become operative on the same date for purposes of this part.

(6) Any provision of the Internal Revenue Code that becomes inoperative on or after the specified date for that taxable year shall become inoperative on the same date for purposes of this part.

(7) Due account shall be made for differences in federal and state terminology, effective dates, substitution of "Franchise Tax Board" for "secretary" when appropriate, and other obvious differences.

(8) Any provision of the Internal Revenue Code that refers to a "corporation" shall, when applicable for purposes of this part, include a "bank," as defined by Section 23039.

(i) Any reference to a specific provision of the Internal Revenue Code shall include modifications of that provision, if any, in this part.

LEGISLATIVE PROPOSAL 03-28
EXECUTIVE SUMMARY

- **Title:** Clarify Authority To Use New-Hire And Contractor Registry Information

- **Problem Statement:** Current law lacks clear authority for FTB to use the Employee Development Department (EDD) new-hire and contractor registries to collect non-tax debts (NTD) other than child support.

- **Proposed Solution:** Add Section 19520 to the Revenue and Taxation Code to clarify FTB's authority to use EDD registries for the collection of any non-tax debt amount.

- **Major Concerns/Issues:** This proposal only provides FTB clear statutory authority to access EDD registry information for NTD purposes. Implementation of this LP is expected to be minimal and the costs to implement are negligible. However, the cost to update the NTD computer system to participate in a data match with EDD is estimated to be minor, less than $50,000. If this LP were enacted in 2003, the department anticipates updating the NTD system by the operative date of January 1, 2004. The costs for the system upgrade would be recovered under the current NTD reimbursement procedure, which provides that the department's costs to administer NTD programs are reimbursed through the amounts the department collects.

- **Revenue:** Collections is estimated at $2.5 million for the 2003-2004 fiscal year, $3.5 million for the 2004-2005 fiscal year, and $2.0 million for the 2005-2006 fiscal year. This estimate assumes that this proposal would be enacted during the 2003 legislative session and the department would update their NTD systems prior to the January 1, 2004 operative date. The estimates above reflect both new collections that would not occur otherwise, as well as the "acceleration" of collections. Approximately three-quarters of the total collections are attributable to vehicle registration, and the balance to court ordered debt.

2003 Departmental Legislative Proposal
LP 03-28

Title

Clarify Authority To Use New-Hire Registry Information

Introduction

This proposal would clarify the authority of the Franchise Tax Board (FTB) to use the information contained in the new-hire and contractor registries maintained by the Employment Development Department (EDD) when collecting on Non-Tax Debt Programs (NTD) administered by FTB.

Current Federal Law

The federal Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) was signed into law on August 22, 1996. PRWORA provides a strengthened child support enforcement program that locates non-custodial parents, establishes paternity when necessary, and establishes and enforces child support orders. One key provision of the PRWORA legislation related to enforcement of child support orders is a requirement that all states have a program to report information about newly hired and rehired employees timely.

Current State Law

FTB is authorized to administer collections for several non-tax programs, including vehicle license fees and court-ordered debts. To collect on non-tax debts, the department is authorized under state law to use the remedies and information sources available for collecting personal income tax debts.

As required under the federal PRWORA legislation, California enacted legislation that requires both a new-hire and a contractor registry. Employers are required to report information on newly hired employees to EDD within 20 days of hiring. The information to be reported includes the employee's name, address, and social security number. This EDD report is generally referenced as the "new-hire registry." The information reported to EDD may be used for specific purposes, such as locating individuals for child support enforcement purposes, administering workers' compensation programs, and verifying eligibility for public assistance. In addition, the information may be provided to FTB for the purpose of tax enforcement.

Similar to the new-hire registry, the "contractor registry" requires a service recipient, who is any individual, person, corporation, or partnership, to report to EDD the name, address, and social security number of the person providing them with a service. A service provider is an individual who is not employed by the service recipient for California purposes, but receives compensation or executes a contract for services performed for the service recipient. Similar to the law for the new-hire registry, the law regarding the contractor registry states that the information obtained by EDD may be provided to FTB for tax enforcement purposes.

Program History/Background

Although information in EDD's new-hire and contractor registries would be helpful to the department's NTD programs, this information is not currently being used for these purposes because of a lack of clear statutory authority to do so.

The statutes authorizing the department to collect the various non-tax debts contain general authorization for the department to use the same collection remedies and resources available for collecting personal income tax debts. Since these EDD registries are available for collecting income tax debts, it would appear that they could also be used for NTD collection. However, as stated above under "State Law" the provisions regarding the EDD registries state that the registry information may be supplied to FTB for specifically identified purposes, including for the purposes of child support collections and or tax enforcement. The term "tax enforcement" is not defined.

Currently, FTB's child support collections program (CSC) matches its debtors accounts with EDD's registries on a bi-monthly basis. CSC accounts are sent to EDD electronically and EDD runs a matching process against the registries. Upon completion, EDD returns a tape of "payor" information for those CSC accounts where a match was found. The "payor" information includes the debtor's name, address, and Social Security number, as well as the payor's name, address, Federal and State Employer Identification Numbers, and any contract information for those CSC accounts that have a match with the contractor registry.

Problem

Current law lacks clear authority for FTB to use the EDD new-hire and contractor registries to collect non-tax debts other than child support.

Proposed Solution

Add Section 19520 to the Revenue and Taxation Code to clarify that FTB has authority to use EDD registries to collect any non-tax debt amount.

Effective/Operative Date of Solution

If enacted in the 2003 legislative session as an administrative measure, this proposal would be operative January 1, 2004.

Justification

Express authority to allow FTB to use the new-hire and contractor registries to collect NTD would give the department access to employer and wage information that is four to nine months more current than is presently available. Therefore, the department would have the information needed to identify and levy a debtor's wage income on a timely basis.

Implementation

Since this proposal only provides FTB clear statutory authority to access EDD registry information for NTD purposes, implementation of this LP is expected to be minimal and as stated below under Departmental Costs, the costs to implement this proposal are negligible. However, the cost to update the NTD computer system to be able to participate in a data match with EDD is estimated to be minor, less than $50,000. Under current law, the department's costs to administer NTD programs are reimbursed through the amounts the department collects. If this LP were enacted in 2003, the department anticipates updating the NTD system by the operative date of January 1, 2004, and recovering the costs under the current NTD reimbursement procedure.

Fiscal Impact

Departmental Costs

Departmental costs to administer this proposal are negligible since this proposal would clarify FTB's authority to access EDD's new-hire and contractor registries for NTD purposes.

Collections Estimate

Collection Impact Assume Enactment in 2003, Operative January 1, 2004 ($ Millions)			
Fiscal Year	2003-04	2004-05	2005-06
Collections Impact	+2.5	+3.5	+2.0

This proposal does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Discussion

Experience with the New Hire Registry for Child Support Collections was considered in estimating the impact on collections for Court Ordered Debt (COD) and Vehicle Registration Collections (VRC). This estimate assumes that this proposal would be enacted during the 2003 legislative session and the department would update its NTD systems prior to the January 1, 2004 operative date. Since this proposal would not be operational until January 1, 2004, the full impact does not occur until fiscal year 2004-05. Ultimately, the enactment date of this proposal determines which fiscal year collections would begin.

The estimates above reflect both new collections that would not occur otherwise, as well as the "acceleration" of collections.

Approximately three-quarters of the total collections are attributable to the VRC, and the balance to COD.

<u>Other Agency/Industry Impacted</u>

In 2001, EDD requested that FTB certify that the information received from the registries and used for NTD collection purposes was used for tax enforcement purposes. Since this proposal would clarify that "tax enforcement" includes NTD collection, FTB would be able to provide EDD the requested certification.

<u>Other States</u>

Phone calls to the appropriate administrative agency and a review of the state government web sites of *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* provided information that these states have new-hire registries as required under federal law. Although the information maintained in the registries are used for child support and welfare programs, none of the states use the registry information for other state collection programs such as income taxes.

LEGISLATIVE STAFF CONTACT

LuAnna Hass	Brian Putler
Franchise Tax Board	Franchise Tax Board
845-7478	845-6333
LuAnna.Hass@ftb.ca.gov	Brian.Putler@ftb.ca.gov

Analyst LuAnna Hass
Telephone # 845-7478
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO LP 03-28

AMENDMENT 1

@@@@Section 19520 is added to the Revenue and Taxation Code to read:

19520. Unless otherwise specifically provided, when a provision of law (including Section 1088.5 and Section 1088.8 of the Unemployment Insurance Code) allows the use of information for tax enforcement purposes, tax enforcement includes the collection of any amount referred to the Franchise Tax Board for collection under a provision of law that authorizes the amount referred to be collected in any manner authorized under law for collection of an unpaid tax liability.

LEGISLATIVE PROPOSAL 03-29
EXECUTIVE SUMMARY

- **Title:** Annual Technical Code Maintenance

- **Problem Statement:** Incorrect cross-references, obsolete provisions, and terminology that are not consistent with current style for drafting legislation can create confusion for taxpayers and the department when applying state law.

- **Proposed Solution:** Correct cross-references, repeal obsolete provisions contained in state law, and amend provisions to reflect the current style for drafting legislation.

- **Major Concerns/Issues:** Obsolete cross-references should be corrected, obsolete provisions should be eliminated, and provisions should be amended to reflect the current style for drafting legislation to prevent confusion for taxpayers and the department when applying state law.

- **Revenue:** This proposal would not affect state income tax revenues.

2003 Departmental Legislative Proposal
LP 03-29

Title

Annual Technical Code Maintenance

Introduction

This proposal would correct cross-references, eliminate obsolete provisions, and make terminology consistent with the current style for drafting legislation. As sections of state law are amended, references to those sections in other parts of the law are sometimes not updated to reflect the amendment. In addition, certain provisions of the law become obsolete through the passage of time, but are not eliminated from the law. Finally, provisions enacted in earlier years may not reflect the current legislative style for drafting legislation.

Problem

Incorrect cross-references, obsolete provisions, and terminology that is not consistent with the current style for drafting legislation can create confusion for taxpayers and the department when applying state law.

Proposed Solution

Correct cross-references, repeal obsolete provisions contained in state law, and amend provisions to reflect the current style for drafting legislation.

Business & Professions Code Section	**Cross-Reference**	**Obsolete Language**	Terminology
17539.3	X		
Education Code Section	**Cross-reference**	**Obsolete Language**	Terminology
32311	X		
Govt. Code Section	**Cross-reference**	**Obsolete Language**	Terminology
7162	X		

Health & Safety Code Section	**Cross-reference**	**Obsolete Language**	Terminology
38040	X		
Vehicle Code Section	**Cross-reference**	**Obsolete Language**	Terminology
5060	X		
R&TC Section	**Cross-reference**	**Obsolete Language**	Terminology
17020.5			X
17020.11			X
17054		X	
17072		X	
17088.5		X	
17088.6		X	
17140.5		X	
17509			X
17510			X
17856			X
18006(b)			X
18036.5		X	
18037		X	X
18037.3		X	
18037.5		X	
18038			X
18039			X
18043		X	
18044		X	
18155.5		X	
18171			X
18171.5			X
18177			X
19022		X	
19023		X	
19024		X	
19062		X	
19182	X		
23036	X	X	
23043.5			X
23772(c)		X	
R&TC Section	**Cross-reference**	**Obsolete Language**	Terminology
23809(d)		X	X
24871.5		X	
24872.4		X	X
24872.5		X	

24991			X

Effective/Operative Date of Solution

If enacted in the 2003 legislative session as a technical measure, this proposal would be operative January 1, 2004.

Justification

Obsolete cross-references should be corrected, obsolete provisions should be eliminated, and provisions should be amended to reflect the current style for drafting legislation to prevent confusion for taxpayers and the department when applying state law.

Implementation

Implementation of this proposal would not significantly impact the department.

Fiscal Impact

Departmental Costs

This proposal would not impact the department's costs.

Tax Revenue Estimate

This proposal would not affect state income tax revenues.

LEGISLATIVE STAFF CONTACT

John Pavalasky
Franchise Tax Board
845-4335
John.Pavalasky@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
Brian.Putler@ftb.ca.gov

Analyst John Pavalasky
Telephone # 845-4335
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS - LP 03-29

AMENDMENT 1

SEC. . Section 17539.3 of the Business and Professions Code is amended to read:

17539.3. (a) Sections 17539.1 and 17539.2 shall not apply to a game conducted to promote the sale of an employer's product or service by his employees, when those employees are the sole eligible participants.

(b) As used in Sections 17539.1 and 17539.2 "person" includes firm, corporation, or association, but does not include any charitable trust, corporation or other organization exempted from taxation under Section ~~23701(d)~~ 23701d of the Revenue and Taxation Code or Section 501(c) of the Internal Revenue Code of 1954.

(c) Nothing in Sections 17539 to 17539.2, inclusive, shall be construed to permit any contest or any series of contests or any act or omission in connection therewith which is prohibited by any other provision of law.

(d) Nothing in Section 17539.1 or 17539.2 shall be construed to hold any newspaper publisher or radio or television broadcaster liable for publishing or broadcasting any advertisement relating to a contest, unless such publisher or broadcaster is the person conducting or holding any such contest.

(e) As used in Sections 17539 to 17539.2, inclusive, the term contest includes any game, contest, puzzle, scheme or plan which holds out or offers to prospective participants the opportunity to receive or compete for gifts, prizes, or gratuities as determined by skill or any combination of chance and skill and which is, or in whole or in part may be, conditioned upon the payment of consideration;

(f) Sections 17539 to 17539.2, inclusive, shall not apply to (1) the mailing or otherwise sending of an application for admission, or a notification or token evidencing the right of admission to, or (2) the operation of a contest, performance, sporting event or tournament of skill, speed, or power or endurance between participants physically present at such contest, performance, sporting event or tournament.

AMENDMENT 2

SEC. . Section 32311 of the Education Code is amended to read:

32311. This article does not apply to:

(a) Any institution classified as an educational institution within the meaning and intent of Section ~~101~~ 501 of the Internal Revenue Code of the United States or of Section 23701d of the Revenue and Taxation Code and which, nevertheless, pays general state and county taxes within this state upon any printing plant and printing equipment owned by it.

(b) The production of forms, materials, and supplies at any state educational institution under the exclusive management and control of the state and authorized by law.

(c) Any publication, printed and produced at any state educational institution under the exclusive management and control of the state for the dissemination of technical or scientific information and which is sold at cost.

(d) Printing which may be classified as "instruction" or "student activity."

AMENDMENT 3

SEC. . Section 7162 of the Government Code is amended to read:

7162. "State tax lien" means a lien created pursuant to Section 8048 of the Fish and Game Code, Section 3423 or 3772 of the Public Resources Code, Section 6757, 7872, 8996, 16063, ~~18881, 26161~~ 19221, 30322, 32363, or 38532 of the Revenue and Taxation Code, or Section 1703 of the Unemployment Insurance Code.

AMENDMENT 4

SEC. . Section 38040 of the Health and Safety Code is amended to read:

38040. As used in this chapter:

(a) "Financial and compliance audit" means a systematic review or appraisal to determine each of the following:

(1) Whether the financial statements of an audited organization fairly present the financial position and the results of financial operations in accordance with generally accepted accounting principles.

(2) Whether the organization has complied with laws and regulations that may have a material effect upon the financial statements.

(b) "Public accountants" means certified public accountants, or state licensed public accountants.

(c) "Independent auditors" means public accountants who have no direct or indirect relationship with the functions or activities being audited or with the business conducted by any of the officials or contractors being audited.

(d) "Generally accepted auditing standards" means the auditing standards set forth in the financial and compliance element of the "Standards for Audit of Governmental Organizations, Programs, Activities, and Functions" issued by the Comptroller General of the United States and incorporating the audit standards of the American Institute of Certified Public Accountants.

(e) "Direct service contract" means any contract provided by a state agency pursuant to Chapter 4 (commencing with Section 38030).

(f) "Nonprofit organization" means an organization described in Section 501(c)(3) of the Internal Revenue Code of 1954 which is exempt from taxation under Section 501(a) of that code or any nonprofit, scientific or educational organization qualified under Section ~~23701(d)~~ 23701d of the Revenue and Taxation Code.

AMENDMENT 5

SEC. . Section 17020.5 of the Revenue and Taxation Code is amended to read:

17020.5. For purposes of this part, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, Section 7701(g) of the Internal Revenue Code, relating to nonrecourse indebtedness, shall ~~apply~~ apply, except as otherwise provided.

SEC. . Section 17020.11 of the Revenue and Taxation Code is amended to read:

17020.11. Section 7701(h) of the Internal Revenue Code, relating to motor vehicle operating leases, shall ~~apply~~ apply, except as otherwise provided.

SEC. . Section 17054 of the Revenue and Taxation Code is amended to read:

17054. In the case of individuals, the following credits for personal exemption may be deducted from the tax imposed under Section 17041 or 17048, less any increases imposed under paragraph (1) of subdivision (d) or paragraph (1) of subdivision (e), or both, of Section 17560.

(a) In the case of a single individual, a head of household, or a married individual making a separate return, a credit of ~~fifty-one dollars ($51) for taxable years beginning on or after January 1, 1987, and before January 1, 1988, and~~ fifty-two dollars ($52) ~~for taxable years beginning on or after January 1, 1988~~.

(b) In the case of a surviving spouse (as defined in Section 17046), or a husband and wife making a joint return, a credit of ~~one hundred two dollars ($102) for taxable years beginning on or after January 1, 1987, and before January 1, 1988, and~~ one hundred four dollars ($104) ~~for taxable years beginning on or after January 1, 1988~~. If one spouse was a resident for the entire taxable year and the other spouse was a nonresident for all or any portion of the taxable year, the personal exemption shall be divided equally.

(c) In addition to any other credit provided in this section, in the case of an individual who is 65 years of age or over by the end of the taxable year, a credit of ~~fifty-one dollars ($51) for taxable years beginning on or after January 1, 1987, and before January 1, 1988, and~~ fifty-two dollars ($52) ~~for taxable years beginning on or after January 1, 1988~~.

(d) (1) A credit of ~~fifty-one dollars ($51) for taxable years beginning on or after January 1, 1987, and before January 1, 1988, fifty-two dollars ($52) for taxable years beginning on or after January 1, 1988, and before January 1, 1998, two hundred fifty-three dollars ($253) for taxable years beginning on or after January 1,~~

~~1998, and before January 1, 1999, and~~ two hundred twenty-seven dollars ($227) ~~for taxable years beginning on or after January 1, 1999,~~ for each dependent (as defined in Section 17056) for whom an exemption is allowable under Section 151(c) of the Internal Revenue Code, relating to additional exemption for dependents. The credit allowed under this subdivision for taxable years beginning on or after January 1, 1999, shall not be adjusted pursuant to subdivision (i) for any taxable year beginning before January 1, 2000.

(2) The credit allowed under paragraph (1) shall not be denied on the basis that the identification number of the dependent, as defined in Section 17056, for whom an exemption is allowable under Section 151(c) of the Internal Revenue Code, relating to additional exemption for dependents, is not included on the return claiming the credit.

(e) A credit for personal exemption of ~~fifty-one dollars ($51) for taxable years beginning on or after January 1, 1987, and before January 1, 1988, and~~ fifty-two dollars ($52) ~~for taxable years beginning on or after January 1, 1988,~~ for the taxpayer if he or she is blind at the end of his or her taxable year.

(f) A credit for personal exemption of ~~fifty-one dollars ($51) for taxable years beginning on or after January 1, 1987, and before January 1, 1988, and~~ fifty-two dollars ($52) ~~for taxable years beginning on or after January 1, 1988,~~ for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

(g) For the purposes of this section, an individual is blind only if either: his or her central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or his or her visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

(h) In the case of an individual with respect to whom a credit under this section is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the credit amount applicable to that individual for that individual's taxable year shall be zero.

(i) For each taxable year beginning on or after January 1, 1989, the Franchise Tax Board shall compute the credits prescribed in this section. That computation shall be made as follows:

(1) The California Department of Industrial Relations shall transmit annually to the Franchise Tax Board the percentage change in the California Consumer Price Index as modified for rental equivalent homeownership for all items from June of the prior calendar year to June of the current calendar year, no later than August 1 of the current calendar year.

(2) The Franchise Tax Board shall add 100 percent to the percentage change figure which is furnished to them pursuant to paragraph (1), and divide the result by 100.

(3) The Franchise Tax Board shall multiply the immediately preceding taxable year credits by the inflation adjustment factor determined in paragraph (2), and round off the resulting products to

the nearest one dollar ($1).

(4) In computing the credits pursuant to this subdivision, the credit provided in subdivision (b) shall be twice the credit provided in subdivision (a).

~~(j) The amendments made to this section by the act adding this subdivision shall be applied only in the computation of taxes for taxable years beginning on or after January 1, 1990.~~

SEC. . Section 17072 of the Revenue and Taxation Code is amended to read:

17072. (a) Section 62 of the Internal Revenue Code, relating to adjusted gross income defined, shall apply, except as otherwise provided.

(b) ~~The amendments to Section 62 of the Internal Revenue Code, made by Section 13213 of the Revenue Reconciliation Act of 1993 (P.L. 103-66), relating to modifications to deduction for moving expenses, shall apply to taxable years beginning on or after January 1, 1996.~~

~~(c)~~ The deduction allowed by Section 17204, relating to interest on education loans, shall be allowed in computing adjusted gross income.

SEC. . Section 17088.5 of the Revenue and Taxation Code is repealed.

~~17088.5. (a) Section 851(b)(3) of the Internal Revenue Code shall not apply.~~

~~(b) This section shall apply in determining whether an entity qualifies as a regulated investment company for income years of that entity beginning after August 5, 1997.~~

~~(c) This section shall not apply to taxable years beginning on or after January 1, 1998.~~

SEC. . Section 17088.6 of the Revenue and Taxation Code is repealed.

~~17088.6. (a) Section 856(c)(4) of the Internal Revenue Code shall not apply.~~

~~(b) (1) Section 856(c)(6)(G) of the Internal Revenue Code shall not apply and in lieu thereof paragraph (2) shall apply.~~

~~(2) Except to the extent provided by regulations of the Secretary of the Treasury under Section 856(c)(5)(G) of the Internal Revenue Code (as redesignated and amended by Public Law 105-34), both of the following shall be treated as income qualifying under Section 856(c)(2) of the Internal Revenue Code:~~

~~(A) Any payment to a real estate investment trust under an interest rate swap or cap agreement, option, futures contract, forward rate agreement, or any similar financial instrument, entered into by the trust in a transaction to reduce the interest rate risks with respect to any indebtedness incurred or to be incurred by the trust to acquire or carry real estate assets.~~

~~(B) Any gain from the sale or other disposition of any such investment.~~

~~(c) This section shall apply in determining whether an entity qualifies as a real estate investment trust for income years of that entity beginning after August 5, 1997.~~
~~(d) This section shall not apply to taxable years beginning on or after January 1, 1998.~~

SEC. . Section 17140.5 of the Revenue and Taxation Code is amended to read:

17140.5. ~~(a)~~ Gross income shall not include compensation for military or naval service within the meaning of Section 574 of Title 50 of the United States Code (Soldiers' and Sailors' Civil Relief Act of 1940) performed by a nonresident not domiciled in this state and attributable to a resident spouse solely because of the application of any community property law or rule.
~~(b) This section shall apply to all taxable years in which the limitation period for the mailing of a notice of a deficiency assessment has not expired.~~

SEC. . Section 17509 of the Revenue and Taxation Code is amended to read:

17509. Sections 413(b)(6) and 413(c)(5) of the Internal Revenue Code, relating to liability for funding tax, shall not ~~be applicable~~ <u>apply</u>.

SEC. . Section 17510 of the Revenue and Taxation Code is amended to read:

17510. ~~For purposes of this part, the provisions of~~ Section 7701(j) of the Internal Revenue Code, relating to ~~federal thrift savings funds~~ <u>Federal Thrift Savings Fund</u>, shall ~~be applicable~~ <u>apply, except as otherwise provided</u>.

SEC. . Section 17856 of the Revenue and Taxation Code is amended to read:

17856. ~~The provisions of~~ Section 751(d)(3) of the Internal Revenue Code, relating to appreciated inventory items subject to tax as a gain on foreign investment company stock, shall not ~~be applicable~~ <u>apply</u>.

SEC. . Section 18006 of the Revenue and Taxation Code is amended to read:

18006. For purposes of determining a credit under Section 18001 (relating to residents) or Section 18002 (relating to nonresidents), both of the following apply:
(a) A member of a partnership shall be allowed to treat his, her, or its pro rata share of net income taxes paid to another state by the partnership as if those taxes had been paid directly by the partner.
(b) (1) A shareholder of a corporation ~~electing to be~~

~~treated as~~ that is an S corporation under Chapter 4.5 (commencing with Section 23800) of Part 11 shall be allowed to treat his or her pro rata share of net income taxes paid to another state by the S corporation as if those taxes had been paid by the shareholder.

(2) This subdivision shall apply only if either of the following requirements is met:

(A) The state imposing the tax does not allow corporations to elect to be treated as an S corporation.

(B) The state imposes a tax on S corporations and the corporation referred to in paragraph (1) has elected to be treated as an S corporation in the other state.

SEC. . Section 18036.5 of the Revenue and Taxation Code is amended to read:

18036.5. ~~(a)~~ In addition to the adjustments to basis provided by Section 1016(a) of the Internal Revenue Code, a proper adjustment shall also be made in the case of property the acquisition of which resulted under Section 18038.5 in the nonrecognition of any part of the gain realized on the sale of other property, to the extent provided in paragraph (4) of subdivision (b) of Section 18038.5.

~~(b) This section shall apply to sales made after August 5, 1997.~~

SEC. . Section 18037 of the Revenue and Taxation Code is amended to read:

18037. ~~(a) The provisions of~~ Section 1033(g)(3)(A) of the Internal Revenue Code, relating to the election to treat outdoor advertising displays as real property, shall not be denied because the taxpayer has, on his or her federal return, elected to expense the asset.

~~(b) Section 13431(b) of the Revenue Reconciliation Act of 1993, relating to effective dates, shall apply.~~

SEC. . Section 18037.3 of the Revenue and Taxation Code is repealed.

~~18037.3. (a) Section 1033(e) of the Internal Revenue Code, relating to livestock sold on account of drought, is modified by substituting the phrase "on account of drought, flood, or other weather-related conditions" in lieu of the phrase "on account of drought" contained therein.~~

~~(b) This section shall apply to sales and exchanges after December 31, 1996.~~

~~(c) This section shall not apply to taxable years beginning on or after January 1, 1998.~~

SEC. . Section 18037.5 of the Revenue and Taxation Code is repealed.

~~18037.5. For sales and exchanges after May 6, 1997, and on~~

~~or before June 30, 1998:~~

~~(a) Section 1034 of the Internal Revenue Code, relating to rollover of gain on sale of principal residence, shall not apply.~~

~~(b) References in Sections 56(e), 163(h), 280A(d), 464(f), 1033(h), 1274(c), and 7872(f) of the Internal Revenue Code, and paragraph (3) of subdivision (c) of Section 18662 of the Revenue and Taxation Code, to Section 1034 of the Internal Revenue Code, shall instead be treated as a reference to Section 17152 of the Revenue and Taxation Code.~~

~~(c) Section 216(e) of the Internal Revenue Code is modified by substituting "such dwelling unit is used as his or her principal residence (within the meaning of Section 17152)" for the phrase "such exchange qualifies for nonrecognition of gain under Section 1034(f)."~~

~~(d) References in Sections 512(a), 1016(a), and 1223(7) of the Internal Revenue Code to Section 1034 of the Internal Revenue Code shall be treated as a reference to that section as in effect on the day before the date of the enactment of the act adding this section.~~

~~(e) Section 1038(e) of the Internal Revenue Code, relating to principal residences, shall be modified to provide that, under regulations prescribed by the Secretary of the Treasury under Section 1038 of the Internal Revenue Code, unless the Franchise Tax Board prescribes otherwise, Section 1038(b), (c), and (d) of the Internal Revenue Code shall not apply to the reacquisition of property and, for purposes of applying Section 17152, the resale of that property shall be treated as a part of the transaction constituting the original sale of the property, if both of the following apply:~~

~~(1) Section 1038(a) of the Internal Revenue Code applies to a reacquisition of real property with respect to the sale of which gain was not recognized under Section 17152.~~

~~(2) Within one year after the date of reacquisition of the property by the seller, that property is resold by him or her.~~

~~(f) Section 1250(d)(7) of the Internal Revenue Code, relating to disposition of principal residence, shall not apply.~~

~~(g) Section 1250(e)(3) of the Internal Revenue Code, relating to principal residence, shall not apply.~~

SEC. . Section 18038 of the Revenue and Taxation Code is amended to read:

18038. ~~The provisions of~~ Section 1040 of the Internal Revenue Code, relating to transfer of certain real property, shall not ~~be applicable~~ apply.

SEC. . Section 18039 of the Revenue and Taxation Code is amended to read:

18039. ~~The provisions of~~ Section 1052 of the Internal Revenue Code, relating to basis established by prior revenue acts, ~~shall be~~is modified as follows:

(a) Section 1052(c) of the Internal Revenue Code shall not ~~be applicable~~ apply.

(b) If the property was acquired, after February 28, 1913, in a transaction to which the Personal Income Tax Law of 1954 applied, and the basis thereof, for purposes of the Personal Income Tax Law of 1954, was prescribed by Section 17747, 17751, 17755, 17756, 17757, 17758, or 17788 of such law, then for purposes of this part the basis shall be the same as the basis therein prescribed in the Personal Income Tax Law of 1954.

SEC. . Section 18043 of the Revenue and Taxation Code is repealed.

~~18043. For purposes of this part, the effective dates for paragraph (3) of Section 1031(a) of the Internal Revenue Code are as follows:~~

~~(a) Paragraph (3) of Section 1031(a) of the Internal Revenue Code shall be applied to any of the following:~~

~~(1) Transfers affected by this section after the effective date of the act adding this section.~~

~~(2) Transfers on or before the effective date of the act adding this section, provided the property to be received in exchange is not received before January 1, 1987.~~

~~(b) In the case of any transfer, on or before the effective date of the act adding this section, which the taxpayer treated as part of a like-kind exchange, the period for assessing any deficiency of tax attributable to this section shall not expire before January 1, 1989.~~

~~(c) If property to be received in the exchange, which the taxpayer treated as part of a like-kind exchange, is identified in a binding contract in effect on the effective date of the act adding this section, and at all times thereafter before the transfer, this section shall be applied--~~

~~(1) By substituting "January 1, 1989" for "January 1, 1987," and~~

~~(2) By substituting "January 1, 1991" for "January 1, 1989."~~

SEC. . Section 18044 of the Revenue and Taxation Code, as added by Stats. 1996, Ch. 954, is repealed.

~~18044. The amendments to Section 1017 of the Internal Revenue Code made by Section 13150 of the Revenue Reconciliation Act of 1993 (P.L. 103-66), relating to exclusion from gross income for income from discharge of qualified real property business indebtedness, shall apply to discharges occurring on or after January 1, 1996, in taxable years beginning on or after January 1, 1996.~~

SEC. . Section 18155.5 of the Revenue and Taxation Code is amended to read:

18155.5. ~~(a)~~ Section 1223 of the Internal Revenue Code, relating to holding period of property, is modified to additionally provide that in determining the period for which the taxpayer has held property the acquisition of which resulted under Section 18038.5 in the nonrecognition of any part of the gain realized on the sale of other property, there shall be included the period for which that other property has been held as of the date of the sale.

~~(b) This section shall apply to sales made after August 5, 1997.~~

SEC. . Section 18171 of the Revenue and Taxation Code is amended to read:

18171. ~~The provisions of~~ Section 1250(b) of the Internal Revenue Code, relating to additional depreciation, ~~shall be~~is modified as follows:

(a) "Depreciation adjustments," as defined in Section 1250(b)(3), shall not include the following:

(1) For taxable years beginning on or after January 1, 1983, amortization under Section 17251 or under Section 188 of the Internal Revenue Code.

(2) For taxable years beginning prior to January 1, 1983, amortization under former Section 17226, relating to pollution control facilities, or former Section 17227, relating to trademarks.

(b) "Additional depreciation," as defined in Section 1250(b)(4) of the Internal Revenue Code, shall include the following:

(1) For taxable years beginning on or after January 1, 1983, amortization under Section 167(k) of the Internal Revenue Code.

(2) For taxable years beginning before January 1, 1983, amortization under former Section 17211.7, relating to low-income rental housing, or former Section 17228.5, relating to certified historic structures.

SEC. . Section 18171.5 of the Revenue and Taxation Code is amended to read:

18171.5. ~~The provisions of~~ Section 1250(a) of the Internal Revenue Code ~~are~~ is modified ~~for purposes of this part~~ as follows:

(a) The date "December 31, 1970" shall be substituted for "July 24, 1969," and "December 31, 1969."

(b) The date "January 1, 1971" shall be substituted for "January 1, 1970."

(c) The date "December 31, 1976" shall be substituted for "December 31, 1975."

(d) The date "January 1, 1977" shall be substituted for "January 1, 1976."

SEC. . Section 18177 of the Revenue and Taxation Code is amended to read:

18177. Section 1275(a)(3) of the Internal Revenue ~~Code~~Code, ~~(relating~~ relating to the definition of tax-exempt ~~obligations)~~ obligation, shall not ~~be applicable~~ apply but instead the term "tax-exempt obligation" means an ~~obligations~~ obligation the interest ~~of~~ on which is exempt from tax under this part.

SEC. . Section 19022 of the Revenue and Taxation Code is repealed.

~~19022. The amount of tax payable by taxpayers subject to the tax imposed by Article 3 (commencing with Section 23181) of Chapter 2 of Part 11 as set forth in a notice mailed to the taxpayers pursuant to Section 23186.1 shall be due and payable on or before the 15th day following the mailing of the notice by the Franchise Tax Board.~~

SEC. . Section 19023 of the Revenue and Taxation Code is amended to read:

19023. For purposes of this article, in the case of a ~~corporation, other than a bank or financial corporation,~~ corporation or an organization described in Section 23731, the term "estimated tax" means the amount which the corporation or organization described in Section 23731 estimates as the amount of the tax imposed by Part 11 (commencing with Section 23001) and the amount of its liability for the tax of each wholly owned subsidiary under Section 23800.5; but in no event shall the estimated tax of a corporation subject to the tax imposed by Article 2 (commencing with Section 23151) of Chapter 2 of Part 11 be less than the minimum tax prescribed in Section 23153.

SEC. . Section 19024 of the Revenue and Taxation Code is repealed.

~~19024. (a) In the case of banks and financial corporations, "estimated tax" means the amount which the bank or financial corporation estimates as the amount of the tax imposed by Part 11 (commencing with Section 23001) at the rate determined by the Franchise Tax Board for the preceding year pursuant to Section 23186.1 and the amount of its liability for the tax of each wholly owned subsidiary under Section 23800.5, but in no event shall the estimated tax of a bank or financial corporation be less than the minimum tax prescribed in Section 23153.~~

~~(b) In case of an increase or decrease in the rate of tax imposed under Section 23151 (tax on general corporations), a bank or financial corporation shall be required to increase or decrease the rate determined by the Franchise Tax Board for the preceding year by the same amount as the change in the rate imposed under Section 23151 determined in accordance with Section 24251 (relating to computation of tax when law changed).~~

SEC. . Section 19062 of the Revenue and Taxation Code is repealed.

~~19062. In the case of a deficiency described in Section 1034(j) of the Internal Revenue Code, the deficiency may be assessed at any time prior to the expiration of the time therein provided.~~

SEC. . Section 19182 of the Revenue and Taxation Code is amended to read:

19182. (a) A penalty shall be imposed for failure to furnish information pursuant to Section ~~18547~~ <u>18628</u> and the penalty amount shall be determined in accordance with Section 6707 of the Internal Revenue Code.

(b) If the person required to register the tax shelter has complied, for federal purposes, with the requirements of Section 6111(d) of the Internal Revenue Code, relating to certain confidential arrangements treated as tax shelters, the person required to register the tax shelter shall be deemed to have complied with the requirements of Section ~~18547~~ <u>18628</u> for purposes of this part and no penalty shall be imposed under subdivision (a).

(c) Article 3 (commencing with Section 19031) of this chapter (relating to deficiency assessments) shall not apply in respect of the assessment or collection of any penalty imposed under this section.

SEC. . Section 23036 of the Revenue and Taxation Code is amended to read:

23036. (a) (1) The term "tax" includes any of the following:

(A) The tax imposed under Chapter 2 (commencing with Section 23101).

(B) The tax imposed under Chapter 3 (commencing with Section 23501).

(C) The tax on unrelated business taxable income, imposed under Section 23731.

(D) The tax on S corporations imposed under Section 23802.

(2) The term "tax" does not include any amount imposed under paragraph (1) of subdivision (e) of Section 24667 or paragraph (2) of subdivision (f) of Section 24667.

(b) For purposes of Article 5 (commencing with Section 18661) of Chapter 2, Article 3 (commencing with Section 19031) of Chapter 4, Article 6 (commencing with Section 19101) of Chapter 4, and Chapter 7 (commencing with Section 19501) of Part 10.2, and for purposes of Sections 18601, 19001, and 19005, the term "tax" shall also include all of the following:

(1) The tax on limited partnerships, imposed under Section 17935 ~~or Section 23081~~, the tax on limited liability companies, imposed under Section 17941 ~~or Section 23091~~, and the tax on registered limited liability partnerships and foreign limited liability partnerships imposed under Section 17948 ~~or Section 23097~~.

(2) The alternative minimum tax imposed under Chapter 2.5 (commencing with Section 23400).

(3) The tax on built-in gains of S corporations, imposed under Section 23809.

(4) The tax on excess passive investment income of S corporations, imposed under Section 23811.

(c) Notwithstanding any other provision of this part, credits shall be allowed against the "tax" in the following order:

(1) Credits that do not contain carryover provisions.

(2) Credits that, when the credit exceeds the "tax," allow the excess to be carried over to offset the "tax" in succeeding taxable years, except for those credits that are allowed to reduce the "tax" below the tentative minimum tax, as defined by Section 23455. The order of credits within this paragraph shall be determined by the Franchise Tax Board.

(3) The minimum tax credit allowed by Section 23453.

(4) Credits that are allowed to reduce the "tax" below the tentative minimum tax, as defined by Section 23455.

(5) Credits for taxes withheld under Section 18662.

(d) Notwithstanding any other provision of this part, each of the following shall be applicable:

(1) No credit shall reduce the "tax" below the tentative minimum tax (as defined by paragraph (1) of subdivision (a) of Section 23455), except the following credits:

(A) The credit allowed by former Section 23601 (relating to solar energy).

(B) The credit allowed by former Section 23601.4 (relating to solar energy).

(C) The credit allowed by former Section 23601.5 (relating to solar energy).

(D) The credit allowed by Section 23609 (relating to research expenditures).

(E) The credit allowed by former Section 23609.5 (relating to clinical testing expenses).

(F) The credit allowed by Section 23610.5 (relating to low-income housing).

(G) The credit allowed by former Section 23612 (relating to sales and use tax credit).

(H) The credit allowed by Section 23612.2 (relating to enterprise zone sales or use tax credit).

(I) The credit allowed by former Section 23612.6 (relating to Los Angeles Revitalization Zone sales tax credit).

(J) The credit allowed by former Section 23622 (relating to enterprise zone hiring credit).

(K) The credit allowed by Section 23622.7 (relating to enterprise zone hiring credit).

(L) The credit allowed by former Section 23623 (relating to program area hiring credit).

(M) ~~For each taxable year beginning on or after January 1, 1994, the~~ The credit allowed by former Section 23623.5 (relating to Los Angeles Revitalization Zone hiring credit).

(N) The credit allowed by former Section 23625 (relating to Los Angeles Revitalization Zone hiring credit).

(O) The credit allowed by Section 23633 (relating to targeted tax area sales or use tax credit).

(P) The credit allowed by Section 23634 (relating to targeted tax area hiring credit).

(Q) The credit allowed by Section 23649 (relating to qualified property).

(2) No credit against the tax shall reduce the minimum franchise tax imposed under Chapter 2 (commencing with Section 23101).

(e) Any credit which is partially or totally denied under subdivision (d) shall be allowed to be carried over to reduce the "tax" in the following year, and succeeding years if necessary, if the provisions relating to that credit include a provision to allow a carryover of the unused portion of that credit.

(f) Unless otherwise provided, any remaining carryover from a credit that has been repealed or made inoperative shall continue to be allowed to be carried over under the provisions of that section as it read immediately prior to being repealed or becoming inoperative.

(g) Unless otherwise provided, if two or more taxpayers share in costs that would be eligible for a tax credit allowed under this part, each taxpayer shall be eligible to receive the tax credit in proportion to its respective share of the costs paid or incurred.

(h) Unless otherwise provided, in the case of an S corporation, any credit allowed by this part shall be computed at the S corporation level, and any limitation on the expenses qualifying for the credit or limitation upon the amount of the credit shall be applied to the S corporation and to each shareholder.

(i) (1) With respect to any taxpayer that directly or indirectly owns an interest in a business entity that is disregarded for tax purposes pursuant to Section 23038 and any regulations thereunder, the amount of any credit or credit carryforward allowable for any taxable year attributable to the disregarded business entity shall be limited in accordance with paragraphs (2) and (3).

(2) The amount of any credit otherwise allowed under this part, including any credit carryover from prior years, that may be applied to reduce the taxpayer's "tax," as defined in subdivision (a), for the taxable year shall be limited to an amount equal to the excess of the taxpayer's regular tax (as defined in Section 23455), determined by including income attributable to the disregarded business entity that generated the credit or credit carryover, over the taxpayer's regular tax (as defined in Section 23455), determined by excluding the income attributable to that disregarded business entity. No credit shall be allowed if the taxpayer's regular tax (as defined in Section 23455), determined by including the income attributable to the disregarded business entity is less than the taxpayer's regular tax (as defined in Section 23455), determined by excluding the income attributable to the disregarded business entity.

(3) If the amount of a credit allowed pursuant to the section establishing the credit exceeds the amount allowable under this subdivision in any taxable year, the excess amount may be carried over to subsequent taxable years pursuant to subdivisions (d), (e), and (f).

(j) (1) Unless otherwise specifically provided, in the case of a taxpayer that is a partner or shareholder of an eligible pass-through entity described in paragraph (2), any credit passed through to the taxpayer in the taxpayer's first taxable year beginning on or after the date the credit is no longer operative may be claimed by the taxpayer in that taxable year, notwithstanding the repeal of the statute authorizing the credit prior to the close of that taxable year.

(2) For purposes of this subdivision, "eligible pass-through entity" means any partnership or S corporation that files its return on a fiscal year basis pursuant to Section 18566, and that

is entitled to a credit pursuant to this part for the taxable year that begins during the last year a credit is operative.

(3) This subdivision shall apply to credits that become inoperative on or after the operative date of the act adding this subdivision.

SEC. . Section 23043.5 of the Revenue and Taxation Code is amended to read:

23043.5. For purposes of this part, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, Section 7701(g) of the Internal Revenue Code, relating to nonrecourse indebtedness, shall ~~apply~~ apply, except as otherwise provided.

SEC. . Section 23772 of the Revenue and Taxation Code is amended to read:

23772. (a) For the purposes of this part--

(1) Except as provided in paragraph (2) every organization exempt from taxation under Section 23701 and every trust treated as a private foundation because of Section 4947(a)(1) of the Internal Revenue Code shall file an annual return, stating specifically the items of gross income, receipts, and disbursements, and any other information for the purpose of carrying out the laws under this part as the Franchise Tax Board may by rules or regulations prescribe, and shall keep any records, render under oath any statements, make any other returns, and comply with any rules and regulations as the Franchise Tax Board may from time to time prescribe. The return shall be filed on or before the 15th day of the fifth full calendar month following the close of the taxable year.

(2) Exceptions from filing--

(A) Mandatory exceptions--Paragraph (1) shall not apply to--

(i) Churches, their integrated auxiliaries, and conventions or association of churches,

(ii) Any organization (other than a private foundation as defined in Section 23709), the gross receipts of which in each taxable year are normally not more than twenty-five thousand dollars ($25,000), or

(iii) The exclusively religious activities of any religious order.

(B) Discretionary exceptions--The Franchise Tax Board may permit the filing of a simplified return for organizations based on either gross receipts or total assets or both gross receipts and total assets, or may permit the filing of an information statement (without fee), or may permit the filing of a group return for incorporated or unincorporated branches of a state or national organization where it determines that an information return is not necessary to the efficient administration of this part.

(3) An organization that is required to file an annual information return shall pay a filing fee of ten dollars ($10) on or before the due date for filing the annual information return (determined with regard to any extension of time for filing the return) required by this section. In case of failure to pay the fee

on or before the due date unless it is shown that the failure is due to reasonable cause, the filing fee shall be twenty-five dollars ($25). All collection remedies provided in Article 5 (commencing with Section 18661) of Chapter 2 of Part 10.2 shall be applicable to collection of the filing fee. However, the filing fee shall not apply to the organization described in paragraph (4).

(4) Paragraph (3) shall not apply to: (A) a religious organization exempt under Section 23701d; (B) an educational organization exempt under Section 23701d, if that organization normally maintains a regular faculty and curriculum and normally has a regularly organized body of pupils or students in attendance at the place where its educational activities are regularly carried on; (C) a charitable organization, or an organization for the prevention of cruelty to children or animals, exempt under Section 23701d, if that organization is supported, in whole or in part, by funds contributed by the United States or any state or political subdivision thereof, or is primarily supported by contributions of the general public; (D) an organization exempt under Section 23701d, if that organization is operated, supervised, or controlled by or in connection with a religious organization described in subparagraph (A).

(b) Every organization described in Section 23701d that is subject to the requirements of subdivision (a) shall furnish annually information, at the time and in the manner as the Franchise Tax Board may by rules or regulations prescribe, setting forth--

(1) Its gross income for the year,

(2) Its expenses attributable to gross income and incurred within the year,

(3) Its disbursements within the year for the purposes for which it is exempt,

(4) A balance sheet showing its assets, liabilities, and net worth as of the beginning of that year,

(5) The total of the contributions and gifts received by it during the year, and the names and addresses of all substantial contributors,

(6) The names and addresses of its foundation manager (within the meaning of Section 4946 of the Internal Revenue Code) and highly compensated employees,

(7) The compensation and other payments made during the year to each individual described in paragraph (6),

(8) In the case of an organization with respect to which an election under Section 23704.5 is effective for the taxable year, the following amounts for that organization for that taxable year:

(A) The lobbying expenditures (as defined in Section 4911(c)(1) of the Internal Revenue Code).

(B) The lobbying nontaxable amount (as defined in Section 4911(c)(2) of the Internal Revenue Code).

(C) The grassroots expenditures (as defined in Section 4911(c)(3) of the Internal Revenue Code).

(D) The grassroots nontaxable amount (as defined in Section 4911(c)(4) of the Internal Revenue Code). For purposes of this paragraph, if Section 23740~~(f)~~ applies to the organization for the taxable year, the organization shall furnish the amounts with respect to the affiliated group as well as with respect to the organization.

(9) Such other information with respect to direct or indirect transfers to, and other direct or indirect transactions and relationships with, other organizations described in Sections 23701a to 23701w, inclusive (other than Sections 23701d, 23701k, and 23701t), as the Franchise Tax Board may require to prevent either of the following:

(A) Diversion of funds from the organization's exempt purpose.

(B) Misallocation of revenue or expense, and

(10) Any other relevant information as the Franchise Tax Board may prescribe.

(c) ~~In addition to the above annual return any organization which is required to file an annual report under Section 6056 of the Internal Revenue Code will furnish a copy of the report to the Franchise Tax Board at the time the annual return is due.~~

~~(d)~~ For the purposes of this part--

(1) In the case of a failure to file a return required under this section on the date and in the manner prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that the failure is due to reasonable cause, there shall be paid (on notice and demand by the Franchise Tax Board and in the same manner as tax) by the exempt organization or trust failing so to file, five dollars ($5) for each month or part thereof during which the failure continues, but the total amount imposed hereunder on any organization for failure to file any return shall not exceed forty dollars ($40).

(2) The Franchise Tax Board may make written demand upon a private foundation failing to file under paragraph (1) of this subdivision ~~or subdivision (c)~~ specifying therein a reasonable future date by which the filing shall be made, and if the filing is not made on or before that date, and unless it is shown that failure so to file is due to reasonable cause, there shall be paid (on notice and demand by the Franchise Tax Board and in the same manner as tax) by the person failing so to file, in addition to the penalty prescribed in paragraph (1), a penalty of five dollars ($5) each month or part thereof after the expiration of the time specified in the written demand during which the failure continues, but the total amount imposed hereunder on all persons for the failure to file shall not exceed twenty-five dollars ($25). If more than one person is liable under this paragraph for a failure to file, all of those persons shall be jointly and severally liable with respect to the failure. The term "person" as used herein means any officer, director, trustee, employee, member, or other individual who is under a duty to perform the act in respect of which the violation occurs.

~~(e) The reporting requirements and penalties shall be applicable for taxable years beginning after December 31, 1970, except that the provisions of subparagraph (B) of paragraph (2) of subdivision (a) shall apply to taxable years ending after December 31, 1970.~~

SEC. . Section 23809 of the Revenue and Taxation Code is amended to read:

23809. There is hereby imposed a tax on built-in gains attributable to California sources, determined in accordance with the provisions of Section 1374 of the Internal Revenue Code, relating to tax imposed on certain built-in gains, as modified by this section.

(a) (1) The rate of tax specified in Section 1374(b)(1) of the Internal Revenue Code shall be equal to the rate of tax imposed under Section 23151 in lieu of the rate of tax specified in Section 11(b) of the Internal Revenue Code.

(2) In the case of an "S corporation" which is also a financial corporation, the rate of tax specified in paragraph (1) shall be increased by the excess of the rate imposed under Section 23183 over the rate imposed under Section 23151.

(b) The provisions of Section 1374(b)(3) of the Internal Revenue Code, relating to credits, shall be modified to provide that the tax imposed under subdivision (a) shall not be reduced by any credits allowed under this part.

(c) The provisions of Section 1374(b)(4) of the Internal Revenue Code, relating to coordination with Section 1201(a), shall not ~~be applicable~~ apply.

~~(d) In the case of a corporation which is subject to the provisions of former Section 1374 of the Internal Revenue Code (prior to amendment by Public Law 99-514), the provisions of that section shall be modified to provide that:~~

~~(1) The tax specified in Section 1374(b)(1) of the Internal Revenue Code shall be equal to the rate of tax imposed under Section 23151 in lieu of the rate of tax specified in Section 11(b) of the Internal Revenue Code.~~

~~(2) In the case of an "S corporation" which is also a financial corporation, the rate of tax specified in paragraph (1) shall be increased by the excess of the rate imposed under Section 23183 over the rate imposed under Section 23151.~~

SEC. . Section 24871.5 of the Revenue and Taxation Code is repealed.

~~24871.5. (a) Section 851(b)(3) of the Internal Revenue Code shall not apply.~~

~~(b) This section shall apply in determining whether an entity qualifies as a regulated investment company for taxable years of that entity beginning after August 5, 1997.~~

~~(c) This section shall not apply to taxable years beginning on or after January 1, 1998.~~

SEC. . Section 24872.4 of the Revenue and Taxation Code is amended to read:

24872.4. (a) Section 856(d)(7)(C)(ii) of the Internal Revenue Code is modified by substituting the phrase "if received by an organization described in subdivision (b) of Section 17651 of Part 10 or Section 23731" for the phrase "if received by an organization described in section 511(a)(2)."

(b) (1) An election under Section 856(e)(5) of the Internal Revenue Code for federal income tax purposes shall be treated for purposes of this part as an election made by the real estate investment trust under Section 856(e)(5) of the Internal Revenue Code for state purposes and a separate election under paragraph (3) of subdivision (e) of Section 23051.5 shall not be allowed.

(2) Any revocation of an election under Section 856(e)(5) of the Internal Revenue Code for federal income tax purposes shall be treated for purposes of this part as a revocation of the election made by the real estate investment trust under Section 856(e)(5) of the Internal Revenue Code for state purposes and a separate election under paragraph (3) of subdivision (e) of Section 23051.5 shall not be allowed with respect to the property for any subsequent taxable year.

(3) If the real estate investment trust fails to make an election under Section 856(e)(5) of the Internal Revenue Code for federal income tax purposes with respect to any property, that property shall not be treated for purposes of this part as foreclosure property, an election under Section 856(e)(5) of the Internal Revenue Code for state purposes with respect to that property shall not be allowed, and a separate election under paragraph (3) of subdivision (e) of Section 23051.5 shall not be allowed with respect to that property.

~~(c) This section shall apply to taxable years beginning after August 5, 1997.~~

~~(d) The amendments made to this section by the act adding this subdivision shall apply to taxable years beginning on or after January 1, 1998.~~

SEC. . Section 24872.5 of the Revenue and Taxation Code is repealed.

~~24872.5. (a) Section 856(c)(4) of the Internal Revenue Code shall not apply.~~

~~(b) (1) Section 856(c)(6)(G) of the Internal Revenue Code shall not apply and in lieu thereof paragraph (2) shall apply.~~

~~(2) Except to the extent provided by regulations of the Secretary of the Treasury under Section 856(c)(5)(G) of the Internal Revenue Code (as redesignated and amended by Public Law 105-34), both of the following shall be treated as income qualifying under Section 856(c)(2) of the Internal Revenue Code:~~

~~(A) Any payment to a real estate investment trust under an interest rate swap or cap agreement, option, futures contract, forward rate agreement, or any similar financial instrument, entered into by the trust in a transaction to reduce the interest rate risks with respect to any indebtedness incurred or to be incurred by the trust to acquire or carry real estate assets.~~

~~(B) Any gain from the sale or other disposition of any such investment.~~

~~(c) This section shall apply in determining whether an entity qualifies as a real estate investment trust for taxable years of that entity beginning after August 5, 1997.~~

~~(d) This section shall not apply to taxable years beginning on or after January 1, 1998.~~

SEC. . Section 24991 of the Revenue and Taxation Code is amended to read:

24991. Section 1275(a)(3) of the Internal Revenue ~~Code~~Code, ~~(relating~~ relating to the definition of tax-exempt ~~obligation)~~ obligation, shall not ~~be applicable~~ apply but instead the term "tax-exempt obligation" means an ~~obligations~~ obligation the interest ~~of~~ on which is exempt from tax under this part.

AMENDMENT 6

SEC. . Section 5060 of the Vehicle Code is amended to read:

5060. (a) An organization may apply to the department for participation in a special interest license plate program and the department shall issue special license plates for that program if the issuance of those plates is required by this article, the sponsoring organization complies with the requirements of this section, and the organization meets all of the following criteria:

(1) Qualifies for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code and ~~subdivision (d) of Section 23701~~ Section 23701d of the Revenue and Taxation Code.

(2) Submits a financial plan describing the purposes for which the revenues described in paragraph (2) of subdivision (e) will be used.

(3) Submits a design of the organization's proposed special interest license plate that, among other things, provides for the placement of the number and letter characters in a manner that allows for law enforcement to readily identify those characters.

(b) Any person described in Section 5101 may apply for special interest license plates, in lieu of the regular license plates.

(c) The design criteria for a special interest license plate are as follows:

(1) The license plate for a passenger vehicle, commercial vehicle, or trailer shall provide a space not larger than two inches by three inches to the left of the numerical series and a space not larger than five-eighths of an inch in height below the numerical series for a distinctive design, decal, or descriptive message as authorized by this article. The plates shall be issued in sequential numerical order or, pursuant to Section 5103, in a combination of numbers or letters.

(2) Special interest license plates authorized under this article may be issued for use on a motorcycle. That license plate shall contain a five digit configuration issued in sequential numerical order or, pursuant to Section 5103, in a combination of numbers or letters. There shall be a space to the left of the numerical series for a distinctive design or decal and the characters shall contrast sharply with the uniform background color. No motorcycle plate containing a full plate graphic design is authorized. Those particular special interest license plates that were issued prior to the discontinuation provided by this paragraph may continue to be used and attached to the vehicle for which they were issued and may be renewed, retained, or transferred pursuant to this code.

(d) (1) No organization may be included in the program until not less than 7,500 applications for the particular special interest license plates are received. Each organization shall collect and hold applications for the plates. Once the organization has received at least 7,500 applications, it shall submit the applications, along with the necessary fees, to the department. The department shall not issue any special interest license plate until an organization has received and submitted to the department not less than 7,500 applications for that particular special interest license plate within the time period prescribed in this section. Advanced payment to the department by an organization representing the department's estimated or actual administrative costs associated with the issuance of a particular special interest license plate shall not constitute compliance with this requirement. The organization shall have 12 months, following the effective date of the enactment of the specific legislation enabling the organization to participate in this program, to receive the required number of applications. If, after that 12 months, 7,500 applications have not been received, the organization shall immediately do either of the following:

(A) Refund to all applicants any fees or deposits that have been collected.

(B) Contact the department to indicate the organization's intent to undertake collection of additional applications and fees or deposits for an additional period, not to exceed 12 months, in order to obtain the minimum 7,500 applications. If an organization elects to exercise the option under this paragraph, it shall contact each applicant who has submitted an application with the appropriate fees or deposits to determine if the applicant wishes a refund of fees or deposits or requests the continuance of the holding of the application and fees or deposits until that time that the organization has received 7,500 applications. The organization shall refund the fees or deposits to any applicant so requesting. In no event shall an organization collect and hold applications for a period exceeding 24 months following the date of authorization as described in paragraph (2) of subdivision (a).

(C) Sequential plate fees shall be paid for the original issuance, renewal, retention, replacement, or transfer of the special interest license plate as determined by the organization and authorized by department's regulations. Those plates containing a personalized message are subject to the fees required pursuant to Sections 5106 and 5108 in addition to any fees required by the special interest license plate program.

(2) (A) If the number of currently outstanding and valid special interest license plates in any particular program provided for in this article is less than 7,500, the department shall notify the sponsoring organization of that fact and shall inform the organization that if that number is less than 7,500 one year from the date of that notification, the department will no longer issue or replace those special interest license plates.

(B) Those particular special interest license plates that were issued prior to the discontinuation provided by subparagraph (A) may continue to be used and attached to the vehicle for which they were issued and may be renewed, retained, or transferred pursuant to this code.

(e) (1) The department shall deduct its costs to develop and administer the special interest license plate program from the revenues collected for the plates.

(2) The department shall deposit the remaining revenues from the original issuance, renewal, retention, replacement, or transfer of the special interest license plate in a fund which shall be established by the Controller.

(f) When payment of renewal fees is not required as specified in Section 4000, or when a person determines to retain the special interest license plate upon a sale, trade, or other release of the vehicle upon which the plate has been displayed, the person shall notify the department and the person may retain and use the plate as authorized by department regulations.

(g) An organization that is eligible to participate in a special interest license plate program pursuant to this article and receives funds from the additional fees collected from the sale of special license plates shall not expend annually more than 25 percent of those funds on administrative costs, marketing, or other promotional activities associated with encouraging application for, or renewal of, the special license plates.

(h) (1) Every organization authorized under this article to offer special interest license plates shall prepare and submit an annual accounting report to the department by June 30. The report shall include an accounting of all revenues and expenditures associated with the special interest license plate program.

(2) If an organization submits a report pursuant to paragraph (1) indicating that the organization violated the expenditure restriction set forth in subdivision (g), the department shall immediately cease depositing fees in the fund created by the Controller for that organization under paragraph (2) of subdivision (e) and, instead, shall deposit those fees that would have otherwise been deposited in that fund in a separate fund created by the Controller, which fund is subject to appropriation by the Legislature. The department shall immediately notify the organization of this course of action. The depositing of funds in the account established pursuant to this paragraph shall continue until the organization demonstrates to the satisfaction of the department that the organization is in compliance or will comply with the requirements of subdivision (g). If one year from the date that the organization receives the notice described in this paragraph, the organization is still unable to satisfactorily demonstrate to the department that it is in compliance or will comply with the requirements of subdivision (g), the department shall no longer issue or replace those special interest license plates associated with that organization. Those particular special interest license plates that were issued prior to the discontinuation provided by this paragraph may continue to be used and attached to the vehicle for which they were issued and may be renewed, retained, or transferred pursuant to this code.

(3) Upon receiving the reports required under paragraph (1), the department shall prepare and transmit an annual consolidated report to the Legislature containing the revenue and expenditure data.

AMENDMENT 7

SEC. . Any section of any act enacted by the Legislature during the 2003 calendar year that takes effect on or before January 1, 2004, and that amends, amends and renumbers, adds, repeals and adds, or repeals a section that is amended, amended and renumbered, repealed and added, or repealed by this act, shall prevail over this act, whether that act is enacted prior to, or subsequent to, the enactment of this act.

TAXPAYER BILL OF RIGHTS PROPOSAL 02-2
EXECUTIVE SUMMARY

- **Title:** Tax Treatment of Dividends Paid By Regulated Investment Companies (RICs)

- **Problem Statement:** The proponent of the proposal contends that California law with regard to distribution of dividends to the shareholders of a RIC results in the indirect taxation of interest on bonds issued both by California (including political subdivisions thereof)[3] and by the federal government is a violation of the California Constitution and federal law. The proponent also contends that the indirect taxation occurs in situations where the RIC fails to meet the 50% statutory eligibility threshold for the payment of exempt-interest dividends.

- **Proposed Solution:** Amend the state exempt-interest dividend test for a RIC to allow the RIC to identify any interest income received from federal or California obligations and paid as a dividend to shareholders to be designated as an "exempt-interest dividend" exempt from tax for state purposes, rather than requiring the RIC to satisfy the current 50% minimum qualified asset threshold.

- **Major Concerns/Issues:** None.

- **Revenue:** The revenue impact of this proposal would be determined by the amount of RIC dividends, exempt under this proposal, that would be otherwise taxable and the marginal tax rates of taxpayers receiving such dividends. It is estimated that this proposal would have an impact of approximately $45 million in each of the first three fiscal years.

---

[3] For purposes of this analysis, any references to "California obligations" is intended to include obligations issued by political subdivisions of this state.

2002 Taxpayer Bill of Rights Legislative Proposal
TP 02-02

Taxpayer Bill of Rights Hearing

Suggested By: Marvin Klotz, EA

Title

Tax Treatment of Dividends Paid By Regulated Investment Companies (RICs)

Introduction

This proposal seeks to modify the California statute that sets forth requirements under which a RIC can distribute tax-exempt interest dividends to its shareholders.

Current State and Federal Law

Federal law provides that obligations of the federal government and the interest paid on those obligations are exempt from state taxation.

Federal law defines a RIC as any domestic corporation or certain trusts that at all times during the taxable year is registered or has an election under the Investment Company Act of 1940 to be treated as a management company or unit investment trust.

Further, federal law requires that a corporation or trust shall be treated as a RIC only if:

- It elects on its tax return to be a RIC,
- At least 90% of its gross income is derived from dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock or securities,
- At the close of each quarter during the taxable year, at least 50% of the RIC's total assets is represented by cash and cash items, government securities, securities of other RICs, and other securities, including equity and debt securities. Other securities, with respect to any one issuer, are limited to not exceed 5% of the total assets, and not more than 10% of the voting securities of the issuer.
- Not more than 25% of the value of its total assets is invested in the securities of one issuer, or two or more issuers of which the taxpayer controls.

Federal law also provides a special rule that if at least 50% of the value of a RIC's total assets consists of state and local bond obligations, that RIC shall be qualified to pay exempt-interest dividends to its shareholders.

Exempt-interest dividends are designated by the RIC as "exempt-interest dividends" in a written notice mailed to its shareholders no later than 60 days after the close of the RIC's taxable year. Exempt-interest dividends are traceable, or directly attributable, to interest received by the RIC during the taxable year on obligations that, when held by an individual, would be exempt from federal taxation. Federal law allows a RIC's shareholders to treat an "exempt-interest dividend" as tax-exempt interest if the RIC meets the 50% asset test described above. If the RIC fails the 50% asset test, then the RIC is not entitled to designate an "exempt-interest dividend" and all dividend amounts are simply treated as a normal taxable dividend paid by a corporation and thus are included in the shareholder's gross income.

State law conforms to federal law with regard to the definition and treatment of a RIC, with two significant modifications. First, for purposes of determining if a RIC is eligible to pay exempt-interest dividends to its shareholders, the RIC may include, in addition to California state and local obligations, any federal obligations in determining whether it meets the 50% asset test described above. As a result, if the RIC meets the 50% threshold requirement under this modified test, exempt-interest dividend amounts include interest received both on the federal and on the California state and local obligations held by the RIC.

Second, for state purposes the determination of whether interest on state and local obligations is exempt from California income taxation is determined by reference to Section 3(c) of Article VIII of the California Constitution, instead of Internal Revenue Code section 103, so that only obligations that pay interest that is exempt from California taxation under the California Constitution can generate exempt-interest dividends for California income tax purposes. The result is that obligations of other states do not qualify and certain California obligations that would not qualify for purposes of the federal 50% test under Internal Revenue Code section 103 do qualify under this modification.

Problem

The proponent of the proposal contends that California law with regard to distribution of dividends to the shareholders of a RIC results in the indirect taxation of interest on bonds issued both by California (including political subdivisions thereof)[4] and by the federal government is a violation of the California Constitution and federal law. The proponent also contends that the indirect taxation occurs in situations where the RIC fails to meet the 50% statutory eligibility threshold for the payment of exempt-interest dividends.

Proposed Solution

Amend the state exempt-interest dividend test for a RIC to allow the RIC to identify any interest income received from federal or California obligations and paid as a dividend to shareholders to be designated as an "exempt-interest dividend" exempt from tax for state purposes, rather than requiring the RIC to satisfy the current 50% minimum qualified asset threshold.

Effective/Operative Date of Solution

This proposal would be effective January 1, 2003.

Justification

For a RIC that fails the 50% asset test, but nonetheless holds any federal and/or California obligations, the proponent of this legislation believes that subjecting the portion of any dividend paid to the RIC shareholders that is attributable to interest received by the RIC on those obligations to state taxation is in conflict with the California Constitution and federal law. The proponent of this legislation believes that the dividend paid to the RIC's shareholders is a direct result of interest received from the California and federal obligations held by the RIC.

Implementation

Implementing this proposal would not significantly impact the department.

[4] For purposes of this analysis, any references to "California obligations" is intended to include obligations issued by political subdivisions of this state.

Fiscal Impact

Departmental Costs

This proposal would not significantly impact the department's costs.

Tax Revenue Estimate

Based on data and assumptions discussed below, this proposal would result in the following order of magnitude revenue losses. Estimates assume only prospective application of the proposal beginning with 2003.

Estimated Revenue Impact of TP02-2 As Introduced at the Taxpayer Bill of Rights Hearing [$ In Millions]		
2003-04	2004-05	2005-06
-$45	-$45	-$45

Tax Revenue Discussion

The revenue impact of this proposal would be determined by the amount of RIC dividends, exempt under this proposal, that would be otherwise taxable and the marginal tax rates of taxpayers receiving such dividends.

Published data on ownership of federal securities indicates the estimated ownership of U.S. Treasury securities by mutual funds at year-end 2001 totaled $260 billion. Applying an average yield of 5% for all maturities suggests potential dividend distributions from RICs of about $13 billion of interest on federal securities. If California's share of these potential distributions is equal to its share of the nation's population (12%) and one-third of this amount is currently taxable, applying a 7% marginal tax rate would result in a revenue loss of $36 million at the 2001 level. Assuming only one-third of potential distributions are currently taxable allows for any existing RIC pass-through of exempt-interest distributions (50% or more quarterly asset test), corporate shareholders, pension and IRA holdings consisting in part of shares of mutual funds with federal securities within the mutual fund portfolio, etc.

Single-state (California) municipal bond funds or unit investment trusts pass-through tax-exempt interest under current law by meeting the quarterly asset test of 50% or more. National municipal bond funds and unit investment trusts have portfolios consisting of state and local bond issues of several different states and generally do not meet California's 50% test. Under this proposal, these funds or trusts would qualify to pass-through tax-exempt dividends to California taxpayers equal to the value of California issues over all issues in the portfolio.

Based on total outstanding debt of California state and local governments and the approximate percentages of this debt held by national municipal bond funds and shareholders that are

California taxpayers, it is estimated that at 2001 levels an additional $65 million of dividends would pass-through tax-exempt. Applying an average marginal tax rate of 9% for these taxpayers would derive additional losses on the order of $6 million.

Allowing for new debt issued, existing debt retired, changing interest rates, and rounding to the nearest $5 million derived the order of magnitude estimates above.

Policy Consideration

The proponent's initial argument about the perceived unconstitutionality of existing state law is premised upon his belief that a RIC is a "conduit" for tax purposes under the Sandra Brown case (*Brown* v. *Franchise Tax Bd.* (1987) 197 Cal.App.3d 300). However, staff believes that this assumption is fundamentally incorrect, as both federal and subsequent state laws both clearly define a RIC to be a corporation or trust. Federal tax provisions providing for the special tax treatment of a RIC, to which California generally conforms, simply do not provide that a corporation or trust qualifying as a RIC is a "conduit" for tax purposes. Therefore, the income received by a RIC does not, absent the special character rules contained in the RIC provisions, retain its character when distributed as a dividend to the shareholder.

This is further demonstrated by the federal RIC provisions, to which California conforms (with modifications described above) that establish the 50% asset threshold requirement for a RIC to be entitled to designate "exempt-interest dividends." In fact, if a RIC were a conduit for income tax purposes, there would simply be no need for a separate statutory provision to permit certain dividends paid by the RIC to be designated as "exempt-interest dividends," since those amounts would already be tax-exempt under a true conduit theory. Therefore, as previously described, and as set forth in regulations governing dividends, the tax-exempt character of income received by a RIC is not preserved when that money is distributed (after possible commingling with other funds) as a dividend to the RIC's shareholders absent the special character preservation rules contained in the RIC statues.

Mr. Klotz's proposal originally suggested simply repealing California's exempt-interest dividend statute. However, based on the preceding analysis, staff believes that this approach would not accomplish the proponent's desired result due to the non-conduit nature of a RIC. The non-conduit nature of a RIC would cause RIC shareholders to be required to include all RIC dividends in their taxable income absent a state statutory "character preservation" rule similar to that found in existing law. As a result, staff has instead provided the attached alternative solution to Mr. Klotz's recommendation, which would not repeal the state exempt-interest asset test entirely, but rather amend that test to eliminate the threshold completely in circumstances where a RIC fails the 50% test, but nonetheless has received some identifiable amount of interest on California and federal obligations. In this situation, the RIC would alternatively be able to designate as an "exempt-interest dividend" an amount equal to the interest received during the taxable year by the RIC attributable to California and federal obligations held by the RIC.

Other Agency/Industry Impacted

RICs with minimal holdings of federal and/or California obligations would have to perform calculations to designate federal and/or California exempt-interest dividends and notify their shareholders on an annual basis. However, many RICs may already be required to do this, or perform similar calculations, due to the differences among the various states regarding the calculation of exempt-interest dividends under each particular state's income tax law.

Analyst Roger Lackey
Telephone # 845-3627
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO TP 02-02

AMENDMENT 1

Section 17145 of the Revenue and Taxation Code is amended to read:

17145. (a) A management company, or series thereof, may annually designate as an ~~is qualified to pay~~ exempt-interest dividend~~s to its shareholders~~ an amount equal to the amount determined under subdivision (b)~~if, at the close of each quarter of its taxable year, at least 50 percent of the value of its total assets consists of obligations which, when held by an individual, the interest therefrom is exempt from taxation by this state~~.

(b) For purposes of this section:

(1) "Exempt-interest dividend" means any dividend or part thereof paid by a management company, or series thereof, in an amount not exceeding the interest received by it during its taxable year on obligations that, when held by an individual, the interest there—from is exempt from taxation by this state, and designated by it as an exempt-interest dividend in a written notice mailed to its shareholders not later than 60 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including exempt-interest dividends paid after the close of the taxable year as described in Section 855 of the Internal Revenue Code) is greater than the excess of:

(A) The amount of interest received by it during its taxable year on obligations, interest on which, if held by an individual, is exempt from taxation by this state, over

(B) The amounts that, if it were treated as an individual, would be disallowed as deductions under Section 17280 of this part or Section 171(a)(2) of the Internal Revenue Code, the portion of that distribution that shall constitute an exempt-interest dividend shall be only that proportion of the amount so designated as the amount of that excess for that taxable year bears to the amount so designated.

(2) "Management company" means a regulated investment company as defined by Section 851 of the Internal Revenue Code.

(3) "Series" means a segregated portfolio of assets, the beneficial interest in which is owned by the holders of a class or series of stock of the management company that is preferred over all other classes or series with respect to that portfolio of assets.

~~(4) "Value" means, with respect to securities (other than those of majority-owned subsidiaries) for which market quotations are readily available, the market value of those securities; and with respect to other securities and assets, fair market value as determined in good faith by the board of directors or trustees, except that in the case of securities of majority-owned subsidiaries that are investment companies, as defined in the Investment Company Act of 1940, that fair value shall not exceed market value or asset value, whichever is higher.~~

(c) An exempt-interest dividend shall be treated by recipients thereof as an item of interest excludable from income.